SCOMM

96:3

COMMITTEE: House O&G DATE: 4/11 TIME: 9:11 AM

SUBJECT: Tesoro Alaska Petroleum Contract

MEMBERS: Rokeberg, G. Davis, S. Ogan, B. Williams, T. Brice B. Davis, D. Finkelstein. Ps 1 of 6

SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Rokeberg	side A 000	Call to order at 9:11 AM
		Members Present -
	012	No Quorum
		Informational Hearing.
Shively	030	John Shively, Kevin Banks.
	040	Give an overview of what we are doing.
		First of all we would like to apologize.
		No bill, this is the result of...
	075	It also had to go before the Royalty board.
		Once the public testimony is closed.
	095	Mapco - Long term agreement.
	108	The Contract is for 3 years.
	125	there are several reasons we believe
		it makes sense to proceed w/this
		contract.
	150	We believe that is a result of in state
		Refining.
	170	I should also indicate to the Legislature.
	180	that concludes
Rokeberg	181	Ques by the committee.
		FYI - Last week in D.C.
	203	Met the President of Tosco Petroleum.
Shively	215	Mr. Chair, that is some info which...
Roke	235	I'm sure that Mr. Renquist.
shive	238	They are
Roke	243	There would be a premium
shive	247	Don't Know
Roke	250	

COMMITTEE: _____ DATE: _____ TIME: _____

SUBJECT: _____

MEMBERS: _____

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SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Shively	252	We have at this point...
	260	I'm not sure
Roke	267	that was my term.
Shively	265	It's a long term deal, to change it,...
Roke	278	What is the advantage
Shive	280	Broker...
Kevin Banks	282	Exxon & Arco are taking....
Roke	295	As opposed to
Banks	297	In the agreement...
Roke	302	Pricing Basket
Banks	308	the pricing basket.... start out w/ crude from several
	325	Tops Tariffs - Pump station #1.
Roke	335	Follow up on some items.... Letter of credit - Volume
Shively	345	I don't know if there was a disa
Banks	349	that's correct
Shive	350	No disagreement.
	355	Tesoro does prefer a 60 day letter of credit.
Navarre	370	the history of
Shive		
Navarre		
Shive		
Banks	376	Never under 90 day letter.
Navarre	379	in negotiating 60
Shive		NC

COMMITTEE: _____ DATE: _____ TIME: _____

SUBJECT: _____

MEMBERS: _____

SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Shive	383	the
Navarre	387	Is the Value of the refinery in Kenai.
Shively	395	I don't Know if it affects their ....
Navarre	407	They have
Shive	408	I agree....
		Mr. Charr.....
	420	the real strength for the state...
Rokeberg	425	One other question ....
Shively	430	They are buying from
Roke	435	Is there a reason
Shively	437	You'll have to ask them.
Navarre	450	I think that is related to the fact they ....
Shively	455	That's a good point, I'd like to follow up....
Roke	462	Any further Ques.
Bernie Smith	470	Mgr. Govt. Affairs for Tesoro....
		opening Statement...
	510	One thing I'd like to talk a little bit about, is the price.
	520	We have had the States best interest...
Rokeberg	530	Thank you. Any Ques.
Navarre	534	Want to thank you.
Roke	536	Thank you...
	540	Mr. Smith I have One ques.
Smith	544	Well...
Roke	548	I don't

COMMITTEE: _____ DATE: _____ TIME: _____

SUBJECT: _____

MEMBERS: _____

_____ Pg 4086

SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Tillinhouse	~~550~~	lets look at the book...
	561	what that does is depict the Price....
	575	it is a premium because ~~Strategy~~ ~~DNR~~ DNR's Rationale on this is ....
	585	Displacement Effect...
	600	Time was run
Navarre	601	Mr. Tillinghouse
Tillinghouse	602	
Navarre	605	The RP - thats adjustable.
Tillinghouse	610	It could go either
Navarre	613	
Tilling	614	Bear in Mind.
Navarre	617	I have a guess
Rake	620	Mr. Smith - the Commissioner.
Smith		
Tilling	636	If I could....
Smith	645	I might add....
Williams	657	Are there ways
Smithe	658	we have worked to get it reduced...
Williams	667	from the Bank
Smith	669	One other point on this...
Tilling	679	there are annual fees....
Williams	683	is there any other way that
Smith	687	we have our refinery put up...
Tilling	694	In addition to the
Rake	697	Thank you I had.
Tilling		
Rake	700	We have to wrap it up.

COMMITTEE: _____ DATE: _____ TIME: _____

SUBJECT: _____

MEMBERS: _____

_____ Pg 5 of 6

SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Roke	703	thanks.
Navarre	side B 000	Displacement.
Banks	001	I'll try to do it quickly...
	020	If we sell oil to Tesoro.....
	045	that may have the impact of.....
Navarre	055	I said that theory flawed?
Shively	071	BP would'd ship to the Gul & unless
Navarre	079	Why would you put that on.
Shive		
Banks	087	focus on Percentages
Navarre	092	If we take
Shive		Gulf
Navarre	098	We take lowest value oil.
Banks	105	What has happened...
Navarre	118	We are, if we take 40,000 barrels away from the....
Banks	135	your way of looking at it. -I'll restate my
Navarre	143	If Tesoro decided they couldn't support this.....
Shively	155	We are making the Assumption...
Navarre	171	If you're going to look at this...
Shively	180	Well, that is correct.....
~~Navarre~~	197	it is our assumption....
Navarre	197	when was
Banks	199	197
Navarre	201	I guess I have a hard time
Shively	210	As the west Coast increases....
		I thin

COMMITTEE: _____ DATE: _____ TIME: _____

SUBJECT: _____

MEMBERS: _____

Pg 6086.

SPEAKER	TAPE#	SIGNIFICANT INFORMATION
Shively	226	If we look at those
Roke	230	G. Davis
Williams	232	I'd like your comments....
Shively	235	It's complicated....
Rokeberg	247	Did you consider the extraordinary burden....
Shively	257	they make a substantial contribution to the state....
G. Davis	271	Thanks you, this gives has the price & weight....
Shively	285	One competitor....
G. Davis	290	that's what I mean
Shive		We Did not....
Roke	247	the length of the contract....
Shively	300	We would not.....
Roke	315	I appreciate that....
Shively	317	We did & thats why
Roke	322	Thank you
		Adjourned at 10:12 Am

SALE OF NORTH SLOPE ROYALTY OIL
TO
TESORO ALASKA PETROLEUM COMPANY

Alaska Department of
NATURAL RESOURCES
DIVISION OF OIL AND GAS

CONTRACT TERMS

- Term

  Three Years
  January 1, 1996 to December 31, 1998

- Quantity

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

- Price
- Purchase Price Reopener
- Security
- In-State Processing
- Local Hire

Price

Exxon's West Coast Royalty Value

- For Tesoro: Price certainty. Retroactive price adjustments due to producer "true-ups" and audits are minimized.

- For Alaska: Price exceeds value of royalty-in-value oil (RIV).

- Price compensates for "displacement effect" and "competitive effect."

Purchase Price Reopener

- Tesoro and the State can renegotiate the price if the export ban is lifted.

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

Security

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

In-State Processing

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

Local Hire

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

IN-STATE BENEFITS

Cash Value Offered

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

AS 38.05.183(1)
and AS 38.06.050(1)

Economic and Social Effects

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

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

Benefits of In-State Refining

- The State imports 15 percent of its petroleum products requirements.

- Imports will be displaced by in-state refining and more aggressive competition will benefit local consumers.

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

Ability of Tesoro to Provide Refined Products

- Tesoro has been in business in Alaska since 1969.

- It commands a 30 percent share of the local market in diesel fuels, jet fuels, and gasoline and it is a major supplier of propane and butane.

AS 38.05.183(4)
and AS 38.06.070(6)

Environmental Effects

- Tankers. No increase in tanker traffic between Valdez and Nikiski is anticipated as a result of the sale. Tesoro's recent refinery expansion means that fewer outbound shipments of products will occur.

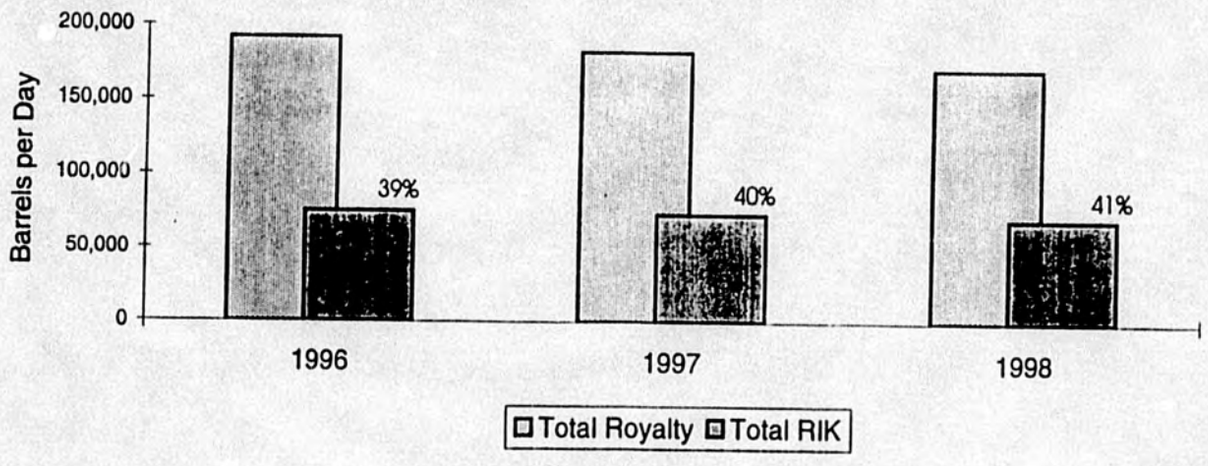
- Air Quality. The sale will not contribute to an increase in emissions at the refinery. Tesoro now operates under ADEC Air Quality Control permits.

- Groundwater and Soil Contamination. Under compliance with ADEC and the EPA, Tesoro is undertaking a long term clean-up. The sale will contribute to the continued economic operation of the refinery and the clean-up program.

AS 38.06.070(7)

Total ANS Royalty and RIK Sales

(Including Mapco and New Tesoro)



TESORO2.XLS, Chart1

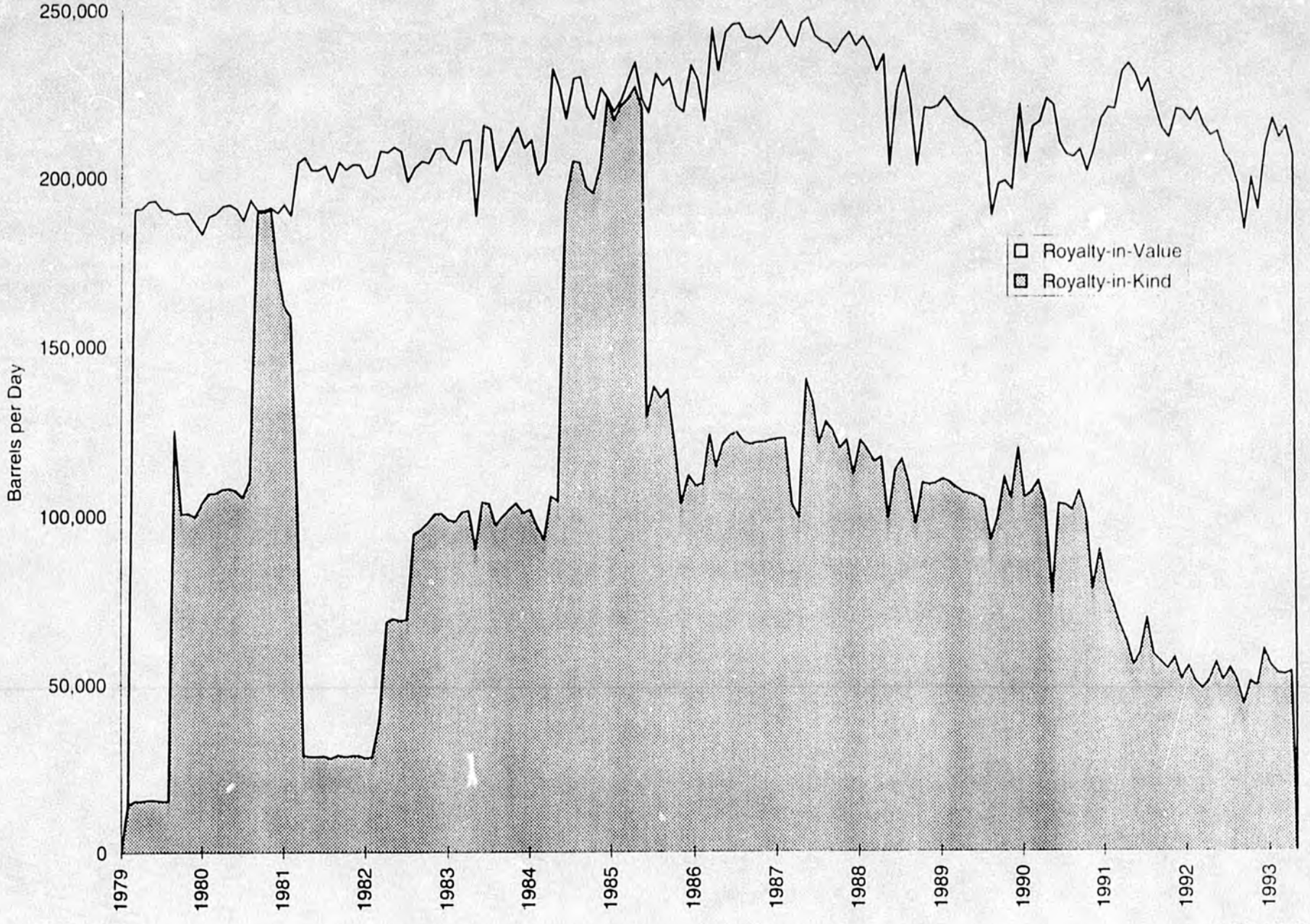
4/10/95, 7:13 AM

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
Kupaurk River Unit	39	38	38	38	37	37	35	32	29
Milne Point	5	7	7	8	9	8	7	6	6
Endicott	13	12	10	9	8	7	6	5	4
Total Royalty:	200	192	182	171	159	147	133	118	108
minus RIV Req'd for Field Cost Allowance									
Prudhoe Bay Unit	14	14	13	12	11	10	9	8	7
Kupaurk River Unit	3	3	3	3	3	3	3	3	2
Milne Point	0	0	0	0	0	0	0	0	0
Endicott	1	1	1	1	1	1	0	0	0
	18	18	17	15	14	13	12	10	10
minus Current RIK Contracts									
Mapco	35	35	35	35	35	35	35	35	35
Tesoro	39	--	--	--	--	--	--	--	--
Total Current RIK Obligation	74	35	35	35	35	35	35	35	35
ANS Royalty Oil Available to Supply New RIK Contracts:									
	108	140	130	121	110	99	86	73	63
New Tesoro @ 30.0%	--	41	38	35	--	--	--	--	--
ANS Royalty Oil Remaining:	108	99	92	86	110	99	86	73	63

Total North Slope RIK and RIV Volumes



RIKHISTB XLS, FIGUREA-2

4/10/95 7:15 AM

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

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

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

Comparison of Tesoro Contract Price and the Value of RIV

TESORO2.XLS, Chart2

4/10/95, 8:52 AM

Alaska State Legislature

HOUSE OF REPRESENTATIVES

Official Business

Representative Norman Rokeberg

State Capitol
Juneau, AK 99801-1182

MEMORANDUM

TO: House Finance Committee Members
Representative Mark Hanley, Co-Chairman
Representative Richard Foster, Co-Chairman
Representative Eldon Mulder
Representative Sean Parnell
Representative Pete Kelly
Representative Gene Therriault
Representative Terry Martin
Representative Vic Kohring
Representative Kay Brown
Representative Ben Grussendorf
Representative Mike Navarre

FROM: Representative Norman Rokeberg, Chair
House Special Committee on Oil & Gas

DATE: April 5, 1995

SUBJECT: Information hearing on the proposed royalty contract with Tesoro

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The House Special Committee on Oil and Gas would like to extend an invitation to interested finance members to attend an informational hearing April 11, 1995, 10:00 -12:00 am, on the proposed three-year royalty contract to sell 40,000 barrels of oil per day to Tesoro Alaska Petroleum Company.

Since legislative approval of the contract is necessary before session adjourns, the hearing will provide an opportunity to get questions answered early. The Department of Natural Resources and Tesoro Alaska Petroleum Company will be present to answer questions on the proposed contract.

STATE OF ALASKA

TONY KNOWLES, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

DIVISION OF OIL AND GAS

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

MAR 30 1995

March 21, 1995

Dear Alaskan:

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

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

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

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

Sincerely,

for Kenneth A. Boyd
Acting Director

Enclosures

printed on recycled paper by C.D.

Preliminary Finding and Determination

to Sell Royalty Oil

to

Tesoro Alaska Petroleum Company

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

March 21, 1995

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

I. Summary

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

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

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

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

Fairbanks Office
119 North Cushman
Fairbanks, Alaska 99701-2879

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

Kenai Peninsula Office
34824 Kalifonsky Beach Road, Suite A
Soldotna, Alaska 99669-9728

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

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

II. Background

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

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

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

III. Discussions of Contract Provisions

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

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

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

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

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

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

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

Price The proposed contract requires Tesoro to pay the same West Coast royalty value received by the state based on the royalty production lifted in the PBU by Exxon. This price meets the statutory requirement that the value of RIK is at least equal to or exceeds RIV. It also differs from the current contract which uses a price based on the volume-weighted average West Coast royalty value reported by the largeest PBU producers, ARCO, BP, and Exxon. The proposed contract price is compared with the current contract and the value of RIV in Table 2.[2]

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

Table 2: RIK Price Calculations--January 1995

Exxon's Royalty Value
Proposed Tesoro Contract Price

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

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

Producer	*Gross Volume*	*PS-1 Value*	*Product of Volume Times PS-1 Value*	*Average Price*
Lisburne Production Center				
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	
Prudhoe Bay IPA				
ARCO	8,807,752.40	$11.61000	$102,258,005.36	
BP Exploration	12,721,772.40	$10.61000	$134,978,005.16	
Exxon	8,807,215.20	$11.11000	$97,848,160.87	
Totals	35,581,428.00		$392,719,310.43	
		Volume-Weighted Average Value:		$11.03720

Volume Weighted Average Price--All Producers
Value of RIV

Producer	*Gross Volume*	*PS-1 Value*	*Product of Volume Times PS-1 Value*	*Average Price*
Lisburne Production Center				
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	
Prudhoe Bay IPA				
Amerada Hess[1]	121,673.40	$11.27400	$1,371,745.91	
ARCO	8,807,752.40	$11.61000	$102,258,005.36	
BP Exploration	12,721,772.40	$10.61000	$134,978,005.16	
Chevron[2]	195,833.10	$11.11000	$2,175,705.74	
Exxon	8,807,215.20	$11.11000	$97,848,160.87	
Louisiana Land and	8,993.30	$11.61000	$104,412.21	
Marathon[3]	11,288.00	$11.61000	$131,053.68	
Mobil[4]	453,693.20	$10.61000	$4,813,684.85	
Phillips[4]	449,246.20	$10.61000	$4,766,502.18	
Shell[3]	31,141.00	$11.61000	$361,547.01	
Texaco[4]	124,049.00	$10.61000	$1,316,159.89	
Totals	36,977,345.20		$407,760,121.91	
		Volume Weighted Average Value:		$11.02730

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 <u>not</u> BP's actual West Coast Value. Assume that BP's West Coast value is the volume-weighted average plus: $0.30

[1]Amerada Hess currently has no prospective formulaic treatment of its royalty value.

[2]Chevron uses a simple average of ARCO, BP, and Exxon.

[3]These producers use ARCO's royalty value formula.

[4]These producers use BP's royalty value formula for West Coast destinations.

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

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

The use of the Exxon royalty value explicitly recognizes that the sale of RIV to Tesoro is a West Coast placement.

Previous RIK Findings have described the so-called "displacement effect" and "competitive effect" that may occur with a state sale of RIK. The "displacement effect" theorizes that any RIK sale by the state replaces ANS sales by North Slope producers to refineries on the West Coast (including Alaska). Although the total volume of ANS sold on the West Coast is the same without a RIK sale, the state's RIK volume displaces the volume that North Slope producers may sell on the West Coast. The producers must then show in their royalty reports that a larger percentage of their oil is placed on the U.S. Gulf Coast with higher transportation costs and a lower netback value. The result is a calculation of the lessees' average royalty value for RIV that reflects a new ratio of West Coast-to-Gulf Coast sales. This proportion of deliveries to the West Coast and Gulf Coast is also reflected in the neback 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 declined in 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.[3] The "competitive effect" is minimized insofar as the

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

volumes of royalty crude considered for nomination under this proposed contract are so small (less than 3 percent) when compared to the total ANS production. Since the state may benefit from the continued operation of the Tesoro facility and, since the consumers of Alaska , may be better off with a more competitive refining industry, these benefits will likely outweigh the impact of these effects.

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

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

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

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

Payments Like the current contract, the proposed contract has specified the timing and due dates associated with the Initial Billing, Initial 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."[4] 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 majuere* in obtaining sufficient marine transportation to haul the additional RIV volume. During this period, the state either has to organize a new RIK purchaser or negotiate with the lessees to take back the RIK. In either event, the state is in a distress sale situation and the letter of credit instrument is intended to protect the state from this event.

The contract includes language that will allow the 75 day letter of credit to be reduced to 60 days if arrangements can be made to ameliorate the potential of a declaration of *force majuere* 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 majuere* by the lessees in the event of a default of the proposed contract by Tesoro may be more difficult to demonstrate with Tesoro's tankers idled and waiting for new customers.

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

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

IV. In-State Benefit Analysis

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

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

Economic Impacts Tesoro reports that it currently employs 189 people in the Kenai Peninsula Borough.[5] This translates as one-in-ten of the manufacturing jobs in the Borough (competing largely with fish processing and timber). Tesoro is, according to the Alaska Department of Labor, number six of the top-ten private sector employers in the Borough. For the most part these are also high-wage jobs with a payroll in the Borough of over $11 million per year.[6]

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

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

Consumption Benefits In 1993, the Corps of Engineers reported "coastwise receipts" of 626,000 tons of petroleum products (185 million gallons). These are domestic shipments

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

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

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.[7]

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

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

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

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

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

[8] Alaska Department of Natural Resources. October 1993. Final Finding of the Director Regarding Oil and Gas Lease Sale 78, Cook Inlet. Anchorage, Alaska.

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

V. Findings and Determination

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

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

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

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

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

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

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.

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 taxs, 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.

AGREEMENT FOR THE SALE AND PURCHASE

OF

STATE ROYALTY OIL

to

TESORO ALASKA PETROLEUM COMPANY

THE STATE OF ALASKA
Department of Natural Resources

Dated as of _____, 1995

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AGREEMENT FOR THE SALE AND PURCHASE OF ROYALTY OIL

THIS AGREEMENT is effective as of _____, 1995 by and between the State of Alaska (State) and Tesoro Alaska Petroleum Company, a Delaware corporation with its principal offices located at 3230 C Street, Anchorage, Alaska 99503 and Tesoro Petroleum Corporation, a Delaware corporation with its principal offices located at 8700 Tesoro Drive, San Antonio, Texas 78217 (collectively Tesoro).

ARTICLE I

DEFINITIONS

As used in this Agreement, the following terms shall have the following respective meanings:

1.1 "Commissioner" means the Commissioner of the Alaska Department of Natural Resources or his designee.

1.2 "Daily Royalty Oil" means the quantity of Royalty Oil produced by the Lessees from the Prudhoe Bay Unit Area in a Day except as provided in Article 2.1(b).

1.3 "Day" means a period of twenty-four (24) consecutive hours, beginning at 12:01 a.m., Alaska Standard Time.

1.4 "Effective Date" shall have the meaning set out in Article VI.

1.5 "Field Cost Agreement" means the Prudhoe Bay Royalty Settlement Agreement effective April 1, 1980.

1.6 "Leases" means the Oil and Gas leases which are subject to the terms of the Prudhoe Bay Unit Agreement.

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

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

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

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

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

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

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

1.14 "TAPS" means the Trans Alaska Pipeline System.

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

ARTICLE II

SALE OF ROYALTY OIL

2.1 Quantity.

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

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

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

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

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

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

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

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

2.4 Reopeners.

2.4(a) Export Ban Reopener. Neither Tesoro nor the State shall have the right to reopen this Agreement, unless the export ban on Alaska North Slope crude now in effect is lifted. Anytime after the export ban is lifted, either Tesoro or the State may reopen this Agreement for purchase price only, by giving the other party one month's prior written notice. 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 Tesoro and the State cannot agree on a price within three months after the written notice to reopen, either Tesoro or the State may terminate this Agreement upon nine months written notice to the other. The purchase price for Oil tendered during any period pending termination shall be the price in effect immediately before giving the

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

2.4(b) Royalty Settlement Agreement Reopener. Tesoro shall not intervene or otherwise participate in any way regarding litigation, styled ANS Royalty Litigation, Case No. 1-JU-77-847, any future royalty settlement agreements with the Lessees, or reopeners or other discussions under or pertaining to royalty settlement agreements. Any judgment resulting from the ANS Royalty Litigation, any future royalty settlement agreements, or any reopener under the Royalty Settlement Agreement shall be conclusively binding upon Tesoro whether or not Tesoro agrees with or consents to the terms of any such judgment, settlement, or reopener. Furthermore, Tesoro has no independent right to invoke any of the provisions of the Royalty Settlement Agreement. If the Royalty Value is modified in the future as a result of a modification of the Royalty Settlement Agreement, a corresponding retroactive modification will be made to the price term of this Agreement and interest will apply to the modification, whether resulting in an overpayment or underpayment, as set forth in Article 5.6. Tesoro agrees to be conclusively bound by any such modification agreed to by the State and Exxon.

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

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

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

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

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

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

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

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

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

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

2.12 In-State Processing. Tesoro agrees to use best efforts to insure that any and all of the Royalty Oil tendered under this Agreement will be processed through Tesoro's refinery near Nikiski, Alaska, or will be exchanged for other crude oil which shall be processed at that refinery. "Process" means the manufacture of refined petroleum products. In no event, however, shall the quantity of Royalty Oil, which must be processed, be less than 80 percent of the volume of Royalty Oil tendered under this Agreement. "Exchange" means: (1) direct trades of equal volumes of crude oil; (2) trades of crude oil involving either cash or volume adjustments, or both, provided that those

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

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

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

ARTICLE III

REPRESENTATION AND OBLIGATIONS OF TESORO

Tesoro warrants, represents, and agrees:

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

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

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

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

ARTICLE IV

MEASUREMENTS AND TESTS

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

ARTICLE V

PAYMENTS AND ACCOUNTING

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

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

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

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

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

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

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

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

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

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

The following illustrates from what date interest will run:

January 1 - 31, 1996 -- Tesoro takes 1996 January production;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ARTICLE VI

TERM

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

ARTICLE VII

DEFAULT OR TERMINATION

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

(i) At any time, Tesoro (a) repudiates any of its covenants or obligations under this Agreement, or (b) fails, within five Days, after written request from the State to provide the State with written affirmation of this Agreement and of Tesoro's intention to perform under this Agreement (together with evidence or assurances of transportation arrangement pursuant to Article 2.8 reasonably satisfactory to the State);

(ii) Tesoro does not pay in full any sum owed under this Agreement at the time when payment is due;

(iii) Tesoro fails to observe or perform any of its other covenants and obligations under Article II;

(iv) Tesoro does not perform any act required or contemplated under this Agreement and: (a) the non-performance cannot be cured; (b) the nonperformance continues for more than thirty Days after the State has notified Tesoro of its nonperformance; or (c) Tesoro has failed to perform the same or any other act required or contemplated under this Agreement;

(v) There is a material adverse change in Tesoro's condition, business, or property which may appreciably affect its ability to perform any of its obligations under this Agreement and Tesoro is unable or unwilling to give the State adequate assurance of continued performance either within five Days of a request for such an assurance or within such

other shorter time period as the State may request under the circumstances;

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

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

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

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

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

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

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

ARTICLE VIII

DISPOSITION OF OIL

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

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

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

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

ARTICLE IX

WAIVER

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

ARTICLE X

VALIDITY

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

ARTICLE XI

FORCE MAJEURE AND CHANGE IN CONDITION

11.1 Effect of Force Majeure. Except for Tesoro's obligations to pay for Oil tendered and to accept and dispose of Royalty Oil, neither party shall be liable for any failure to perform when performance is prevented, in whole or in substantial part, by force majeure after good faith efforts to perform. The term 'force majeure" shall mean an event or condition not within the reasonable control of the party claiming the benefit of this excuse. If, however, any material obligation of Tesoro is excused or suspended by a force majeure for sixty successive Days or more, the State will have the right to terminate this Agreement. Before the State exercises its right to terminate, Tesoro and the State shall in good faith negotiate to restore the benefits and obligations of the force majeure condition.

11.2 Responsibility. If a party believes that force majeure has occurred, the party shall immediately notify the other party of its claim of force majeure. If force majeure occurs, that occurrence shall, so far as possible, be remedied with reasonable diligence. Except for Tesoro's obligations to pay for Oil tendered and to accept and dispose of Oil, the disabled party's obligations to perform that are affected by the force majeure shall be suspended from the time that notification occurs until the disability should have been remedied with reasonable diligence, and for no longer.

ARTICLE XII

NOTICES

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

If to the State:

State of Alaska
Commissioner of Natural Resources
400 Willoughby Avenue
Juneau, Alaska 99801

and

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

If to Tesoro:

Gaylon H. Simmons
Tesoro Alaska Petroleum Company
8700 Tesoro Drive
San Antonio, Texas 78217
Telecopy Number: (210) 283-2031

12.2 Change of Address. Each party may change its address for notice by giving written notice of the change.

ARTICLE XIII

RULES AND REGULATIONS

This Agreement is subject to all present and future valid laws, orders, rules and regulations of the United States, the State of Alaska, and any duly constituted agency of the State of Alaska.

ARTICLE XIV

SOVEREIGN POWER OF THE STATE

This Agreement shall not be interpreted as a limit on the State of Alaska's exercise of any of its sovereign or regulatory powers, whether conferred by constitution, statute or regulation, including, but not limited to, its regulatory power over the Leases. Its exercise of any sovereign or regulatory power will not operate or be deemed to enlarge any rights of Tesoro or to limit or impair any obligations or liability of Tesoro under this Agreement.

ARTICLE XV

SECURITY

15.1 Letter of Credit. Seventy five Days before the Date of First Delivery, Tesoro shall cause to be issued and delivered to the State an irrevocable stand-by letter of credit, with an effective date no later than the Date of First Delivery, issued for the benefit of the State by a State or national banking institution of the United States ("Issuer"), which is insured by the Federal Deposit Insurance Corporation and has an aggregate capital and surplus of not less than One Hundred Million Dollars ($100,000,000), or other banking institution acceptable to the State in its sole discretion. The

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

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

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

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

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

ARTICLE XVI

PREFERENTIAL HIRING AND NON-DISCRIMINATION

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

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

ARTICLE XVII

APPLICABLE LAW

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

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

ARTICLE XVIII

WARRANTIES

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

ARTICLE XIX

AMENDMENT

This Agreement may be supplemented, amended, or modified only by written instrument duly executed by the parties.

ARTICLE XX

SUCCESSORS AND ASSIGNS

No assignment, pledge, or encumbrance of this Agreement shall be made by either party without the written consent of the other party. The Commissioner or the Commissioner's designee may grant or deny such consent. Subject to the above requirements in this article, this Agreement will be binding upon and inure to the benefit of each of the parties and its successors and permitted assignees.

ARTICLE XXI

HEADINGS

Headings used in this Agreement are for convenience only and shall not affect its construction.

ARTICLE XXII

RECORDS

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

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

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

ARTICLE XXIII

INTERPRETATION OF TERMS AND CONDITIONS

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

ARTICLE XXIV

COUNTERPARTS

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

SIGNATURES

the State: THE STATE OF ALASKA

_____

Commissioner
Department of Natural Resources

Date: _____

Tesoro Alaska Petroleum Company: TESORO ALASKA PETROLEUM COMPANY

By: _____

Its: _____

Date: _____

Tesoro Petroleum Company TESORO PETROLEUM COMPANY

By: _____

Its: _____

Date: _____

ACKNOWLEDGEMENT

State of Alaska)
) ss.
Third Judicial District)

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

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

_____
Notary Public in and for Alaska
My commission expires:_____

ACKNOWLEDGEMENT

State of _____)
) ss.
_____)

THIS IS TO CERTIFY that on the _____ day of _____, 1996, before me, appeared _____ of Tesoro Alaska Petroleum Company, San Antonio, Texas; that _____ executed that document under legal authority and with knowledge of its contents; and that this act was performed freely and voluntarily upon the premises and for the purposes stated in the document.

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

_____

My commission expires:_____

ACKNOWLEDGEMENT

State of _____)
) ss.
_____)

THIS IS TO CERTIFY that on the _____ day of _____, 1996, before me, appeared _____ of Tesoro Petroleum Company, San Antonio, Texas; that _____ executed that document under legal authority and with knowledge of its contents; and that this act was performed freely and voluntarily upon the premises and for the purposes stated in the document.

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

_____

My commission expires:_____

EXHIBIT A

CALCULATION OF ROYALTY VALUE

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

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

Exxon's Royalty Value = $117,328,207.31 ÷ 10,570,115.33 = $11.09999

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

CALCULATION OF INTEREST

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

Mechanics of the calculations include:

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

Example 1: Initial Billing

Assumptions:

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

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

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

Note:

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

Example 2: Initial Adjustment

Assumptions:

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

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

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

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

$13,763,987.60

Overpayment for January: ($123,987.60)

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

Interest due = $123,987.60 x (11%/365) x 23 = ($859.42)

Credit due Tesoro for next month's billing = ($124,847.02)

Example 3: Subsequent Adjustment

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

Assumptions:

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

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

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

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

Underpayment for January deliveries: $136,400.00

Days of interest in first quarter (Initial Billing date plus 3 business days through March 31st) = 53
Days of interest in second quarter (April 1 through June 30th) = 91
Days of interest in third quarter (July 1 through July 5) = 5
Interest for first quarter = $136,400.00 x (11%/365) x 53 = $2,178.66
Interest for second quarter = ($136,400.00 + $2,178.66) x (12%/365) x 91 = $4,145.97
Interest for third quarter =($136,400.00 + $2,178.66 + $4,145.97) x (12%/365) x 5 = $234.62

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

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

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

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

I. Summary

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

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

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

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

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

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

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

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

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

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

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[2]/ AS 38.06.050(a).

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

Among the document's more rigorous requirements are these:

***a. Price.** Tesoro would be obligated, under the proposed contract, to pay a substantial "premium" above the price that the state receives from either: (I) 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. [4]/ As Chart 1 illustrates, except for those remote-market imports, Alaska's refinery production virtually equals in-state demand.

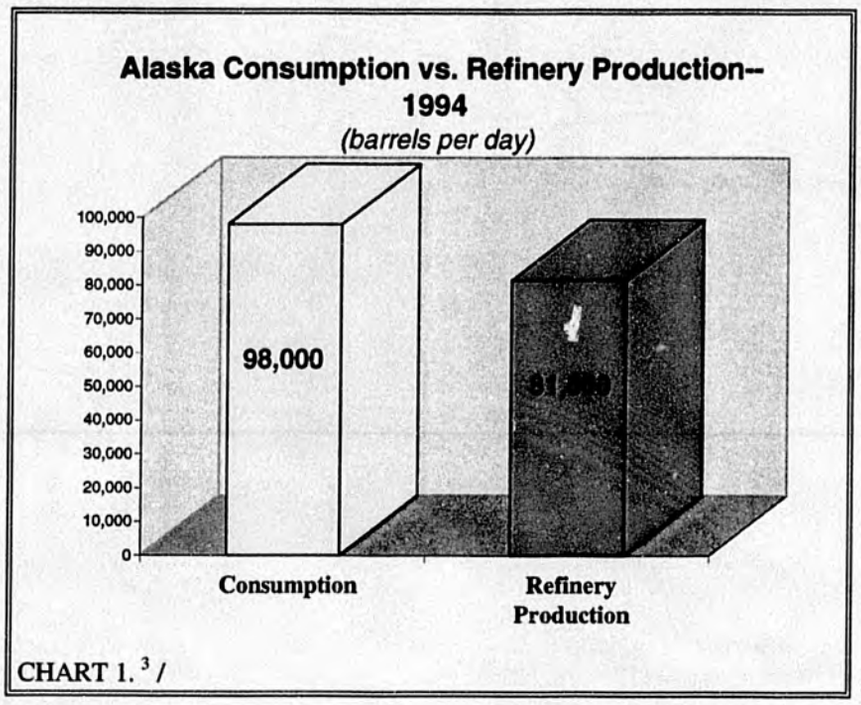

CHART 1. [3] /

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

[4]/ 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. [5]/ 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, [6]/ 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). [7]/

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[5]/ Purvin & Gertz Study, prepared for MAPCO Petroleum (1992) at 4.
[6]/ AS 38.05.183(d).
[7]/ 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. [8]/

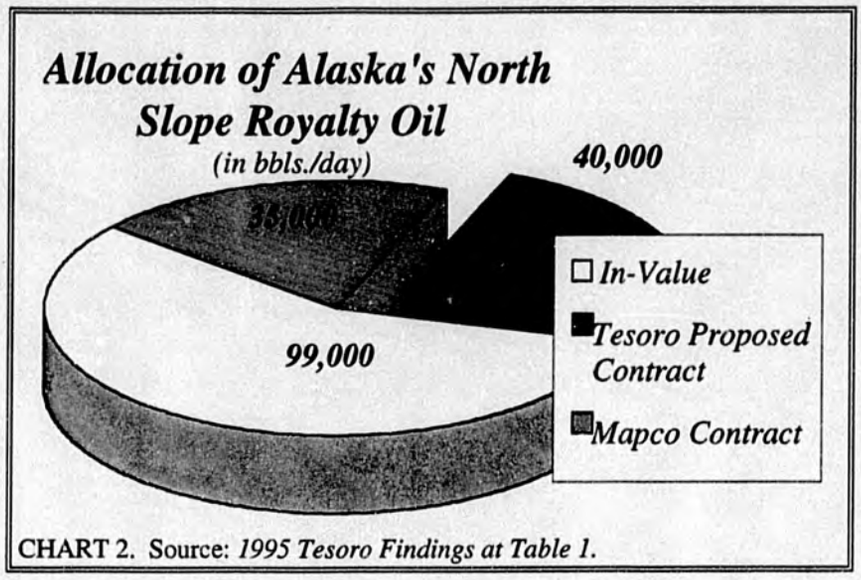

CHART 2. Source: *1995 Tesoro Findings at Table 1.*

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.

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[8]/ 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 accomodate 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. Into 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 competitiors. And, the principal component of that additional cost--the cost of tanker transportation from Valdez

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

MAPCO's and Petro Star's proximity to the pipeline not only affords them cheaper crude; it also enables them to dispose of unmarketable refinery product at only a nominal charge--while Tesoro, conversely, must pay dearly to ship that same product south. In particular: Tesoro and MAPCO both produce substantial quantities of heavy "residual" oil, which has no market in Alaska. MAPCO is able to return that product to the TAPS line, paying only a $.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. [9]/ 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

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

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

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

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

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

In its *Amerada Hess* settlements with the principal ANS producers, DNR defined "value" as a volume-weighted average of the values of ANS oil in different markets. ANS crude is sold along both the West and Gulf coasts, and, of late, Gulf Coast prices have generally been $.90-$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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[10]/ *See, e.g., Petro Star Findings* at 10-11. As discussed in the following text, no premium was charged Petro Star.

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

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

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

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

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 valueing 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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[12]/ 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.

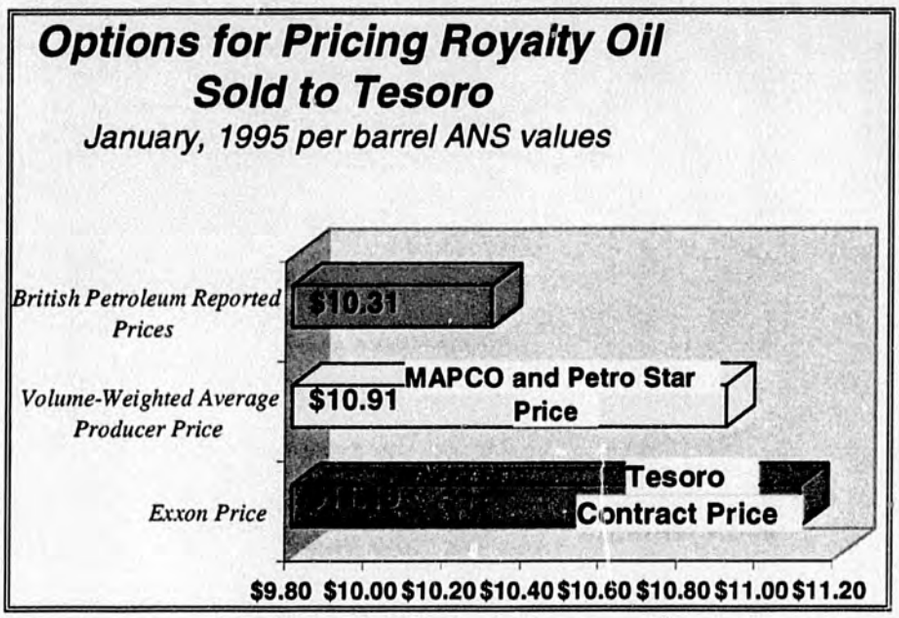

CHART 3. *Source: 1995 Tesoro Findings at Table 2.* [13]/

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:

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[13]/ 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. [14]/ 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). [15]/

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[14]/ 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.

[15]/ *Petro Star Findings* at 14.

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

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

The increase is apparently motivated by DNR's newly-heightened concern over the availability of tanker capacity to ship any royalty oil that it, or the ANS producers, might find themselves holding in the event of Tesoro's default. In that respect, the contract does allows 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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[16]/ *Id.* at Art. 7.1(ii).

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

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

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

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

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

2. Tesoro's Solvency

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

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

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

1994 Tesoro Findings at 9-10.

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

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

The document continues:

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

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

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

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

(4) Even if the agreement is 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.

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

Executive Summary

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

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

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

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

Because the proposed contract must be reviewed by the Alaska Royalty Oil and Gas Development Advisory Board ("Royalty Board") before being presented to the legislature, [2]/ legislation approving the contract should be ripe for introduction about April 24, 1995. However, and given that time is short, the legislature ought to begin evaluating the proposed contract now.

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

[2]/ AS 38.06.050(a).

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. From either perspective, the proposed contract offers a very good deal to the State of Alaska:

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

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

2. 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: (I) 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.