ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672

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# MEMORANDUM

# State of Alaska

Department of Revenue

TO: Bob Baratko
Director Admin. Services

DATE: Jan 26, 1995

FILE NO:

TELEPHONE NO: (907) 277-5627 ext.265

THRU: John Pilkinton
Director Oil and Gas Audit

SUBJECT: ANS EXPORT BAN FISCAL NOTE

FROM: Chuck Logsdon
Petroleum Economist

Apparently there is some confusion over my response to a question about the value of the ANS Export Ban during my testimony before the Senate Finance committee. As I recall I gave a several part response in which I mentioned that one, albeit very rough, way of making the estimate would be to look at the price difference between ANS at the West and ANS at the Gulf. Currently this spread is about $.50/bbl or using the rule of thumb of $130 million in general fund unrestricted revenue for every $1.00/bbl, this would be $65 million.

The other thing I stated was that even if the price on the West and Gulf were the same, the transportation cost savings alone would account for $20 million in additional revenues.

The fiscal note I prepared for SJR 3 estimates benefits of $80 million and uses current prices and transportation costs. The estimate was arrived at as follows:

ANS Price Before Export Ban Lifted
less Tanker Cost

| | Gulf | West |
|---|---|---|
| | 16.90 | 16.40 |
| | -3.30 | -1.20 |
| Net | 13.60 | 15.20 |

Weighted Average Net = 14.96
(85% West, 15% Gulf)

ANS Price After Export Ban Lifted
less Tanker Cost

| Japan | West |
|---|---|
| 16.65 | 16.90 |
| -1.70 | -1.20 |
| 14.95 | 15.70 |

Weighted Average Net = 15.59
(85% West , 15% Japan)

Impact on Wellhead = 15.69-14.96 = $.63/bbl or Revenue = 130 * .63 = **81.575 million**

The analysis on the following page breaks the total of $81.575 million down into the amount accounted for by transportation cost savings component and the amount accounted for by higher sales price.

<u>Transportation Effect</u>

| | | |
|---|---|---|
| | $3.30 | |
| less | 1.70 | |
| | 1.60 | gross transport savings /bbl |
| less | .25 | (lower price in Japan than U.S. Gulf since Middle East closer to Japan) |
| | 1.35 | net transport savings /bbl |
| * | .15 | |
| | 0.2025 | net impact on ANS wellhead (15% shipped to Japan) |

Total Transport benefit by the rule of thumb = 130*.2025 = **$26.325 million**

<u>Price Effect</u>

| | | |
|---|---|---|
| | $16.90 | after export price |
| less | 16.40 | before export price |
| | 0.50 | gross increase in sales price |
| * | .85 | |
| | .425 | net impact of higher price on ANS wellhead (85% shipped to West) |

Total Price Effect benefit by the rule of thumb = 130*.425 = **$55.25 million**

Total Price and Transportation Effect = $26.325 + $55.25 = **$81.575 million**

The fiscal note prepared for SJR 3 goes to zero at that point at which our forecast of ANS production declines to the point that there is no longer a surplus of ANS for sale on the West Coast in the second half of FY 1997.

Finally please note that at a minimum, regardless of the price of oil we would achieve a $26.325 million increase in revenues if the ban were lifted in FY 1996.

FEB 27 1995

# STATE OF ALASKA

TONY KNOWLES, GOVERNOR

**DEPARTMENT OF REVENUE**

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February 22, 1995

Representative Norman Rokeberg
Alaska State Legislature
State Capitol
Juneau, Alaska 99801-1182

Dear Representative Rokeberg:

I have reviewed the testimony that I gave at the House Special Committee on Oil and Gas February 7, 1995 and would like to provide you with some additional information, comments and corrections to what I stated at that time.

PROPERTY TAX

The state levies a property tax on only that property used to explore for, produce, or transport oil or gas (except for gas distributed for retail use in-state) at 20 mills. The municipalities also may levy property taxes against this same property to the extent to which it is found within their jurisdiction. The tax levied by the municipalities on this property is paid to the muncipality by the taxpayers and taken as a credit against their state property tax.

I have spoken with the state assessor and have a better idea about the relationship between the state and the municipalities in which the property is located. First, the boroughs are restricted to 30 mill property tax rate to fund their operating budget (AS 29.45.090(a)). This cap is further subject to a per capita limit based on 225% of the statewide average per capita value of all property in the state (AS 43.56.010(c). Second, there is no limit on the ability of municipalities to tax to pay their bonds. As a result there is no effective limit on local taxes other than the ability to incur bonded indebtedness.

As a result the boroughs do for example assess other property in the municipality which is not subject to the state property tax. In theory the municipalities, depending on the value of non-oil property and their bonded indebtedness, could receive the entire 20 mill state tax on petroleum production property located within their boundaries.

SEVERANCE TAX

I am enclosing a copy of a paper I presented in 1992 which covers a lot of the issues in oil taxation and particularly the severance tax which you may find interesting.

A review of my testimony indicates that I suggested that the State could raise "oil prices". Unfortunately this is not true. I meant to say we can raise or lower tax rates.

With respect to the ELF, the formula as originally conceived did not have any exponents. The exponents were added as the tax bill evolved in the legislative process.

I also mis-spoke with respect to the way in which the Department handles the issue of wells drilled with multiple completions or those wells which produce from more than one pool of oil. The Department currently holds that a well is a hole in the ground regardless of the number of completions or lateral extensions in that hole. A given hour of a single well's operation may not be counted more than once. That is, in calculating the ELF, such a well must be allocated to the different zones which it is being used to produce. This is based upon a formal hearing decision that is presently under appeal to the Superior Court.

The severance tax is collected monthly, not quarterly as stated in my testimony.

## VALUE ISSUES

In my testimony on value I believe I caused a lot of confusion about whether I was talking about the way royalty values are determined or about how severance tax values are determined. I hope that the following outline will help clarify the issue.

Severance Tax Value: Value at the point of production is determined by subtracting from the sales price or prevailing value the actual costs of transporting the oil to the place of sale or transfer to a producer's refinery. The average spot price as reported for the month in *Platt's Oilgram Price Report (Platt's)* for Alaska North Slope (ANS) deliveries to West Coast and Gulf Coast destinations is used when the oil is moved into a producer's own refinery. Prices for ANS crude oil deliveries to markets without a spot quote in *Platt's* or production from Cook Inlet are based on West Coast ANS spot price on a fixed dollar differential. The sales price is used if the oil is sold to a third party unless the sales price is $.10/bbl less the spot price during the month of delivery, in which case the spot price would be required.

## ROYALTIES

Royalty Value: There are a number of formula settlements for oil and gas valuation purposes. The most important ones are for ARCO, EXXON, and BP North Slope oil production. All these formulas share one important feature and that is a market basket of crude oils. There are two market baskets one for the West Coast and one for the Gulf Coast. They are developed monthly since the royalty payment, like the severance tax payment, is due monthly. The market basket is also based on spot prices as reported in *Platt's*.

The crude oil in the market basket for the West Coast consists of West Texas Sour (a crude oil produced in Texas similar in quality to ANS), Line 63 (a pipeline blend of crude oil sold in California similar in quality to ANS), THUMS (a heavy California crude oil), Kern River (a heavy California crude oil), ANS for California delivery, Dubai (an Arabian Peninsula crude oil exported by the emirate of Dubai similar in quality to ANS), and Oriente (the export grade oil similar to ANS produced in Ecuador).

The crude oil in the market basket for the Gulf Coast consists of West Texas Sour , ANS Gulf, Dubai, and Oriente.

| West Basket Crude Oils | Weights | Gulf Basket Crude Oils | Weights |
|---|---|---|---|
| West Texas Sour | .15 | West Texas Sour | .26 |
| Line 63 | .30 | ANS Gulf | .31 |
| THUMS | .06 | Dubai | .09 |
| Kern River | .06 | Oriente | .34 |
| ANS Calif. | .18 | | 1.00 |
| Dubai | .05 | | |
| Oriente | .20 | | |
| | 1.00 | | |

**ARCO Formula**: Basket times 1.03 + or - $.50/bbl. If ANS Spot price falls within this range then ANS Spot is used otherwise use Basket times 1.03. To determine the price at the wellhead multiply the ANS Spot price (or the Basket times 1.03) by .97554, then subtract the TAPS and other filed Alaska pipeline tariffs.

**BP Formula**: West Price = Basket West times 1.0164
Gulf Price = Basket Gulf times 1.0021
less actual tanker cost less TAPS and other filed Alaska pipeline tariffs
Mid-Continent Price = Gulf netback + $0.50/bbl
Virgin Islands Price = .5 times West netback + .5 times Gulf netback

**EXXON Formula**: Price the same as BP
less $1.25/bbl tanker cost less TAPS and other filed Alaska pipeline tariffs until February 1, 1996 when $.14/bbl of this amount subject to monthly adjustment based on change in market basket after February 1, 1996. Plus $0.708/bbl portion of charge subject to escalation monthly by the producer price index (PPI).

INCOME TAX

There are two generally applied concepts which distinguish the petroleum corporate income from the general corporate income tax. First, the apportioned income base for the petroleum corporate tax is based on world-wide income rather than the water's edge approach used for the general corporate tax. Second, for most oil companies operating in Alaska, the apportionment factors are property, extraction, and sales, while for regular corporations the factors are property, payroll, and sales. There is a federal tax credit for qualified enhanced oil recovery projects. A portion of these federal tax credits attributable to the corporation's Alaska business activity (as yet undetermined and subject to audit) may be applied against the corporation's state corporate income tax liability.

I hope that this clarifies some of the complex tax issues I testified to at the February 7, 1995 meeting. If you have further questions please feel free to give me a call.

Sincerely,

Chuck

Charles L. Logsdon
Petroleum Economist

Winter 1992–supplement

# Alaska's relationship with the major oil companies

*by*

*Dr Charles L. Logsdon*

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# Alaska's relationship with the major oil companies

**Dr Charles L. Logsdon**
State of Alaska Department of Revenue

## Introduction

OIL WAS DISCOVERED at Swanson River on Alaska's Kenai Peninsula in 1957. The start of commercial production from the Swanson River field in 1958 and Statehood for the territory of Alaska in 1959 marked the beginning of what has become a long and often bitter but mutually profitable relationship between the major oil companies and the State of Alaska.

When Alaska became a State it was allowed to select 108 million acres of Federal land. As part of this entitlement, the State selected land on the Alaska North Slope. These lands proved to contain the largest oil field ever discovered in North America at Prudhoe Bay as well as a host of other smaller oil fields. The ownership of the land containing most of the current oil production in the entire State makes Alaska unique among the producing areas of the US. Not only is the State of Alaska able to tax resources produced within its sovereign boundaries, but it is an owner of a significant amount of the resources produced.

In this short paper I would like to explore the relationship between the major oil producers and the State of Alaska.

## Dividing up the rent

Alaska's relationship over time with the oil companies is dominated by the issue of how much of the resource rent goes to the companies, how much goes to the State of Alaska, and how much goes to the Federal government. Alaska has experimented with almost all conceivable methods of extracting some part of the resource rents generated by oil field development that are possible under the US Constitution. The list includes a royalty ownership interest, lease bonuses and rents, production excise taxes, income taxes, property taxes, and reserves taxes. Today, in 1992, Alaska still relies on all but the reserves tax to collect the petroleum rent.

Alaska's recent economic development has been inextricably linked with the oil industry. Major oil production began in the late 1950s and Statehood for Alaska occurred in 1959. There is even a fairly good argument that, without oil, Alaska would not have had the indigenous income base to support Statehood.

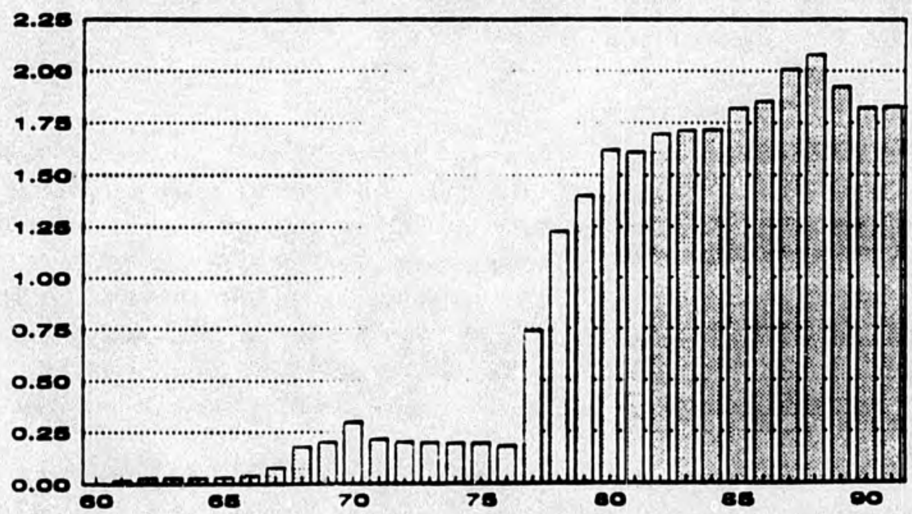
Alaska's approach to determining its share of the rent and its method in achieving this goal has evolved along with the growth in the State's petroleum economy.

The initial discovery of oil in the Cook Inlet led to a burst of oil exploration activity throughout Alaska in the late 1950s and early 1960s. Other oil discoveries were made in Cook Inlet, mainly offshore, so that by the late 1960s Alaskan oil production had reached 200,000 b/d.

The discovery of the largest oil field in North America at Prudhoe Bay in 1968 redefined the parameters of the relationship between Alaska and the oil companies, raising questions about how the oil wealth generated from this field would be taxed and how the field would be developed.

**Figure 1** illustrates the tremendous impact the development of the Alaska North Slope oil fields has had on Alaskan oil production and subsequently on the evolving relationship between the State and the oil producers. Alaskan oil production is currently in decline as the huge Prudhoe Bay field is being depleted. This critical factor will usher in a new phase in the relationship between Alaska and the oil companies.

**Figure 1**
**Alaska oil production, 1960–91**
*mb/d*



## Alaska North Slope oil profit

The issue of the size of the pie has been the major feature of Alaska's relationship with the oil producers. Obviously, an oil production level over 1.5 million b/d can generate considerable wealth depending on the level of price. Given the distance from market and the high production costs, the issue of petroleum resource value in Alaska has been the focus of lengthy disputes between the State and the oil companies.

Alaska's point of collecting the rent through its severance tax and royalty share is at the petroleum production wellhead. The wellhead value is determined by subtracting the transportation costs incurred in shipping North Slope oil from the sales price at the point of sale. The sales price is determined by third party sales, internal transfer price booked into the producer's refinery, or value at the point of exchange.

The companies producing ANS are highly integrated multinational corporations. Not only do they own the non-royalty production, but they own the pipelines, tankers, refineries, and petroleum product distribution networks. Given this business structure, there is tremendous incentive to shift profit away from the highly taxed wellhead into downstream activities. For this reason, Alaska has spent hundreds of millions of dollars in legally challenging all aspects of how much of the value of the crude oil can be attributed to the resource.

The disputes over sales value have involved conflicting market theories about pricing in a crude oil market muddied by artificial institutional constraints, like the ban on exporting ANS crude oil and the resulting requirement that all ANS crude shipments be made on expensive US flagged tankers to both the US West Coast and distant markets in the Eastern US and Caribbean.

The West Coast market for crude oil has long been the subject of legal controversy. Small producers and royalty owners in California have felt for many years that the major producers have acted so as to depress the wellhead price of California production. At the same time, as ANS production came on line in 1977, a very large surplus of sour crude oil developed on the West Coast.

Three producers, British Petroleum (BP), Atlantic Richfield (ARCO) and EXXON, control roughly 95% of the ANS production. BP, with 50% of the ANS, rapidly established themselves as the price leader in the West Coast market. BP until recently had no downstream business interest on the West Coast and based its marketing and pricing decisions in that market on both its transportation costs to the Gulf Coast and the ability to exchange ANS on the West Coast for crude oil to run through its Mid-America and Gulf Coast refineries.

The net result of all these and other factors was a pricing policy by BP which resulted in a West Coast price which generated a higher realized wellhead value than sales east of Panama.

**Table 1**
**Alaska royalty value market baskets**

| West Coast royalty basket | | Gulf Coast royalty basket | |
|---|---|---|---|
| **Crude oil** | **Weight** | **Crude oil** | **Weight** |
| West Texas Sour | .15 | West Texas Sour | .26 |
| Line 63 | .30 | ANS (Gulf) | .31 |
| THUMS | .06 | Dubai | .09 |
| Kern River | .06 | Oriente (USGC) | .34 |
| ANS (Calif) | .18 | | |
| Dubai | .05 | | |
| Oriente | .20 | | |

In addition to the value issue, Alaska and the ANS producers continue to dispute the transportation costs deducted from the sales price to arrive at the wellhead value. The largest dispute involved the appropriate charge for shipping oil through the Trans-Alaska Pipeline. This multi-billion dollar dispute was settled in 1986 with the adoption of the TAPS Settlement which established a cost of service methodology for establishing the maximum allowable tariff. The settlement resulted in a front-loaded tariff allowing early capital recovery by the owners in exchange for low tariffs through the 1990s.

So far, Alaska has settled the legal disputes over the value for royalty production although the issue is still in dispute for severance taxes. The settlements establish alternative formula approaches to future value. The ARCO formula uses a market basket of spot crude values (table 1) and an allowance for marine transportation costs equal to 3.7 per cent of the basket value to determine a Valdez netback. The wellhead value is then calculated by deducting the allowable TAPS tariff. The BP and EXXON royalty value formula uses the same market basket approach although there are additional adjustments for West Coast and Gulf Coast deliveries.

Actual marine transportation costs are allowed as a deduction under the BP formula agreement. The transportation deduction for EXXON West Coast deliveries starts with a basic deduction of \$1.18/b for direct costs and an additional 6% or \$.07/b for indirect costs. 12% of the direct costs are subject to an index based on oil prices relative to the average destination value for the first six months in 1992. Beginning February 1, 1996, the direct costs are adjusted upward by 60%.

Alaska has also instituted an estimated tax procedure which requires that taxpayers adjust severance tax payments to the equivalent of the ANS spot market value for both West Coast and Gulf Coast markets. This is intended to reduce the size of future disputes over value.

**Table 2**
**ANS profitability from the incremental dollar**

| | |
|---|---|
| Royalties | 0.125 |
| Severance tax | 0.131 |
| State income tax | 0.010 |
| State take | 0.266 |
| Federal tax | 0.249 |
| Aftx profit | 0.485 |

**Table 3**
**Current ANS profitability**
*$/b*

| | |
|---|---|
| Lower 48 sales price | 16.00 |
| less tanker cost | 1.50 |
| Valdez netback | 14.50 |
| less TAPS | 3.45 |
| Field price | 11.05 |
| less royalty | 1.29 |
| less severance tax | 1.46 |
| less property tax | 0.53 |
| less operating expense | 1.50 |
| less depreciation | 1.50 |
| Before tax income | 4.77 |
| less State income tax | 0.07 |
| less Federal income tax | 1.60 |
| **ANS production profit** | **3.10** |

Current estimates of ANS profitability are developed in the following tables. Table 2 contains estimates of the share of profit from the incremental dollar earned. Table 3 contains estimates of the average per barrel profit using an assumed price and production cost.

As will be seen, a brief review of changes in the State's severance tax structure illustrates the pattern of changes in oil taxes. Initially taxes were increased to generate needed revenues to fund public services associated with a growing economy. With the development of the mammoth Prudhoe Bay field, taxes were increased to meet some notion of a fair share of the rent from a one-time depletable resource. Finally, recent changes have been made to ensure that the State continues to receive what has come to be perceived as a fair share. The fair share has by default come to be viewed as one-third to Alaska, one-third to the companies, and one-third to the Federal government.

## Review of Alaskan oil tax changes

A historical review of the State's share of the economic rent generated by oil extraction is illustrated in figure 1.

The first bulge in Alaska's share shown in **figure 2** reflects the implementation of an oil production hardware property tax in 1975 just prior to Prudhoe Bay production. The second Alaska share bulge resulted from the oil price crash of 1986. Since Alaska's production tax includes an $0.80/b floor and royalty interest is not directly profit sensitive, Alaska's relative share of the economic rent increases as profits shrink.

## Severance tax

Alaska has one of the world's most unusual production taxes. An examination of the chronology of how the current method of taxation came to be is a good

**Figure 2**
**Alaska's share of petroleum rent**
%

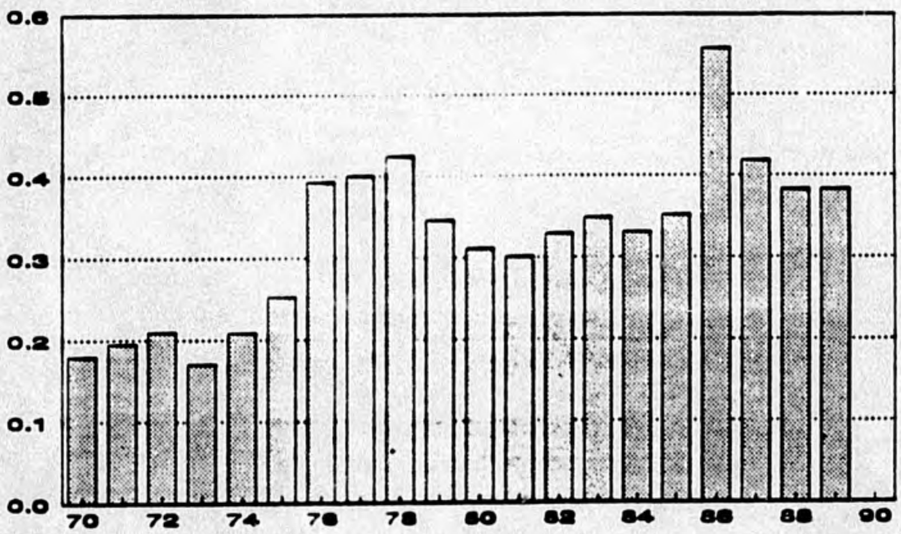


Figure 3
Alaska's average effective severance tax, 1955–91

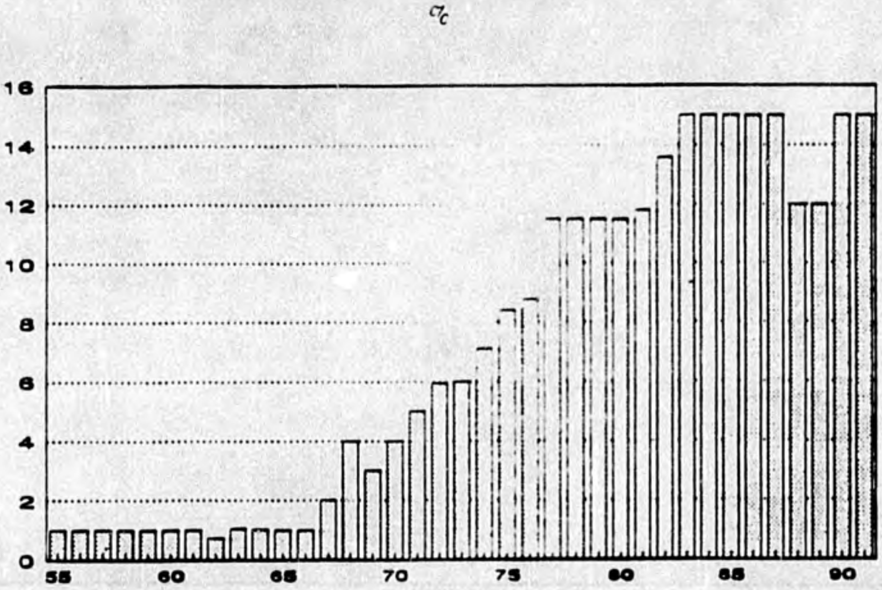



illustration of how the relationship between Alaska and the oil producers developed over time. As can be seen in figure 3, the effective severance tax rate on Alaskan production began to increase as oil and gas production in Alaska began to increase — generally in response to increasing production and revenue needs by the state.

The current oil severance tax structure is the result of a significant number of changes over time made so that an excise tax on production would very roughly mirror the profitability of the oil field being produced.

As shown in Figure 3, the severance tax was originally enacted by the Alaska legislature in 1955 at a rate of 1 per cent of gross value. In 1967 the legislature enacted an additional 1 per cent disaster severance tax to raise money to assist the victims of the Fairbanks flood in that year. In 1968 the rate of the "regular" severance was raised to 3 per cent of the gross value of petroleum production, leaving in place the 1 per cent disaster severance tax. 1968 also was the year in which oil was discovered at Prudhoe Bay.

In 1969 the legislature amended the severance tax structure to a "stair-stepped" rate schedule based on the average daily production per well. The rates started at 3 per cent for the first 300 barrels per day, five per cent on the next 700, 6 per cent on the next 1,500 and 8 per cent on the production exceeding 2,500 barrels per day. The 1 per cent disaster severance tax was repealed.

Looking ahead to Prudhoe Bay production and the potential high transportation costs of a Trans Alaska Pipeline, a severance tax floor based on a cents-per barrel tax with a credit for royalties paid to the State was passed into law in 1972. This was done to prevent the dissipation of resource rent due to unacceptably low wellhead prices resulting from inadequate tariff regulation or construction cost overruns. Although this initial approach to using a floor for the severance tax was soon repealed, a new schedule of three stair stepped rates for value or cents per barrel was introduced and modified in 1973. All of which effectively raised oil taxes.

Finally in 1977, the 3-step schedule was replaced by the Economic Limit Factor (ELF). The ELF was a formula designed to provide a scaled severance tax rate based on average production per well from a producing oil field. The severance tax rate was set at 12.25 per cent subject to the ELF reduction. The formula for the ELF was as follows:

$$ELF = (1 - (pel/tp))^\wedge(460/pel)$$

where pel = production per well at the economic limit or that level of production per well necessary to cover direct operating costs. The pel was presumed to have a value of 300 b/d unless the tax payer could provide evidence that more was needed.

tp = average daily production per well

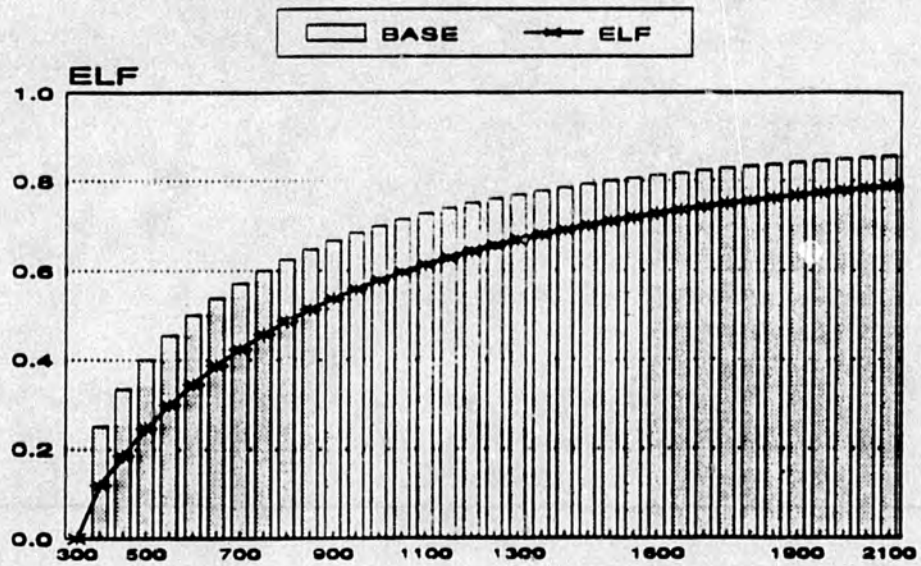
Notice that, in the formula, if average production per well is equal to 300 b/d, the ELF takes a value of zero and no severance tax is due. The exponent (^ 460/300) was adopted as a policy variable which reduces the calculated value of the basic ELF fraction for all levels of well productivity (**figure 4**).

The 1977 change was motivated primarily by the desire to capture a "fair" share of the resource rent from development of the gigantic Prudhoe field while keeping a lid on the taxes paid by the older less prolific Cook Inlet oil fields.

The 1981 change in the severance tax was a direct response to the imposition in 1977 of the oil and gas corporate income tax. The separate accounting oil and gas corporate income tax was part of the tax legislation, mentioned above, which was enacted in anticipation of major production from Prudhoe Bay. The major oil companies filed suit against the tax. State concern over the contingent liability was great enough that the tax was repealed in 1981. The severance tax was modified to make the change "revenue neutral".

The modification defined a new and old field tax rate. The new field rate was set at 12.25 per cent for the first 5 years of production after which the field pays the old field a nominal 15 per cent rate. All fields in production prior to 1981 would pay the 15 per cent rate. Further, a rounding rule was introduced into the

Figure 4
**Original economic limit factor**
*b/d per well*




ELF calculation. If during the first 10 years of production the calculated value of ELF was 0.7 or greater, the ELF was rounded up to 1.0. After 10 years of production the rounding rule was dropped.

The 1981 oil tax change was clearly designed around the Prudhoe Bay oil field which was at the time expected to begin to decline in 1987, 10 years after production start-up. It raised the effective severance tax on this field from around 10.5 per cent to 15.0 per cent, while leaving the tax on all other fields in the State unchanged.

This key feature in Alaska's oil tax policy i.e. increasing taxes on big oil fields, while decreasing taxes on less prolific fields, was evidenced again in the most recent change in oil tax law in 1989. Prudhoe Bay production continued at high levels through 1988. As a result of the expiration of the rounding rule, the tax rate on Prudhoe Bay dropped and Prudhoe Bay tax revenues fell by roughly $185 million between 1987 and 1989 (Alaska Revenue Sources, 1990).

Once again concern over protection of what was perceived as the State's fair share of the rent resulted in new tax legislation which modified the ELF to include field size as a component of the formula. Under the new formula, the effective severance tax rates on Prudhoe Bay returned to almost 15 per cent. At the same time the rate on Kuparuk increased from roughly 8.7 per cent to 12.5 per cent. The effective rate on all other fields decreased or stayed the same.

### Tax stability concerns

The changes in the severance tax reviewed above involved very intense political battles. In most cases the higher taxes levied were the result of extremely narrow political victories. Alaskans are very conscious of the high cost environment both consumers and businesses face in the state. Additionally, most people are aware of Alaska's dependence on the oil industry for its economic base. This economic dependency derives from both direct and indirect employment in the industry but also State spending of oil revenues. Oil revenues provide 85 per cent of State revenues which fuel a level of State per capita expenditures many times the national average (Goldsmith *et al*).

As with most tax issues, stability is in the eye of the beholder. Compared with other oil-producing areas of the world, Alaska's tax system is no more unstable than some and significantly more stable than others (Gaffney *et al*). Certainly, however, every major change in petroleum taxes since 1974 has increased the industry tax bill, with the exception of the change in 1981.

## Alaska — the owner State

Current Alaskan Governor Walter J. Hickel has promoted the theme of Alaska as the owner State. Through its royalty interest in North America's largest oil field this is a significant feature of the State economy. Alaska's ownership interest in its oil production is based on a contractual relationship with the oil companies in which the State leases the right to explore for and develop petroleum resources from State-owned lands.

Most of the current oil production comes from leases which were issued under a competitive bonus bid system carrying a 12.5 per cent royalty. Under current law, the Alaska Department of Natural Resources (ADNR) is required to conduct a pre-sale analysis prior to each sale to determine not only the petroleum potential of areas to be leased but also the socio-economic and environmental impacts of the sale. The pre-sale analysis serves as the basis for developing lease terms. Although the ADNR has at times offered leases using sliding scale royalties and net profit share terms, most recent sales have been cash bonus bid with a fixed royalty generally set at 12.5 per cent.

### Leasing

Most of Alaska's identifiable sedimentary basins have already either been leased or offered for lease. Obviously this means that the decision to explore and drill these lands will depend on the willingness of the lessors to explore their holdings. This willingness is a function of available capital and alternatives for oil exploration. Clearly cost of exploration and development represent a significant hurdle in Alaska, given the extreme climate and relative inaccessibility and distance from markets.

Alaska has also offered additional incentives to encourage the exploration of State lands, such as the exploration incentive credit and the discovery royalty. The exploration incentive credit has in the past been offered as an encouragement to drill geologically attractive leases in which the State has retained a net profit share interest. The exploration incentive credit can be granted by the Commissioner of the Department of Natural Resources and is set at a maximum of 50% of the cost of drilling the first exploration well on a lease. The discovery royalty provision set the royalty rate for the lease with the discovery well at 5 per cent for 10 years following discovery. Only leases issued prior to 1969 are eligible for this royalty reduction.

## Petroleum ownership issues

Over 90 per cent of oil production in Alaska is controlled by three companies — British Petroleum (46 per cent), ARCO (27 per cent), and EXXON (20 per cent). One issue which has often been overlooked by policy makers is the relative concentration of ownership of not only producing leases but also, as a result, most of the surface facilities and transportation network which enables oil production to be marketed off the Alaska North Slope.

It is not clear how much this concentration of ownership impacts the ability of the State to attract new exploration capital or the extent to which it effects the rate of development of known petroleum deposits. If potential bidders on State leases believe that they will face disadvantageous costs imposed by current owners to move their production off the North Slope and out of Alaska, they will be effectively excluded from the area.

The Trans-Alaska oil pipeline is a regulated common carrier and as such operates to insure that all shippers have equal access at published tariffs. The pipeline has an ownership structure called a divided interest. This means that each pipeline owner has a separate tariff for the portion of the pipeline that it owns. As a result, the capacity of the pipeline is pro-rated among the shippers so that all shippers face essentially the same overall average tariff. This should insure that access and charge for using the TAPS are not a barrier to new entrants.

The issue of marine transportation does, however, raise some additional interesting issues. Dramatic increases in insurance requirements for ships loading oil at the Valdez terminal in the wake of the EXXON Valdez oil spill have served to increase the cost of shipping barrels of ANS, both by raising the average cost of operating tankers loading at Valdez and by reducing the number of tankers available to move crude oil. Unless a tanker can be used to move a significant number of cargos, the large fixed insurance cost acts as a barrier to entering this market.

So far the effect of this change in market condition has been to leave small producers of ANS with three alternatives: 1. to sell to the big producers; 2. to pay very high marine transportation charges: or 3. to try to sell to the Alaska in-State refiners. It appears that they are probably doing all of the above. In fact sales to in-State refiners have gone up enough that MAPCO, the refinery in Fairbanks, has reduced the amount of Alaska royalty oil it buys. Because MAPCO pays a price for Alaska royalty oil very close to the average wellhead value reported by the biggest producers, this implies that some producers are selling at a discount reflecting their marketing disadvantage.

## Environmental costs

Environmental costs have long been an issue in Alaska resource development. Legislation clearing the way for the construction of TAPS itself was only narrowly approved and then only in response to the Arab oil embargo. Alaskan residents have generally elected officials who have sided with the oil companies in seeking to overcome environmental opposition to oil field development. A case in point is the unanimous bi-partisan support in both executive and legislative branches to open up the Arctic National Wildlife Refuge for exploration.

Attitudes in the State towards protecting the environment may be "greening up" in the aftermath of Exxon Valdez oil spill. However, it is probably safe to say that Alaska has a track record of willingness to compromise on environment versus development issues, in order to earn additional oil revenues.

The resource rent generated from the development of high value petroleum resources makes it possible to invest in environmental impact mitigation while still earning an attractive rate of return. The issue becomes difficult when the marginal increment in environmental mitigation comes at a very high cost. Certainly environmental regulation has contributed to delays in the development of the Niakuk oil field.

Alaska's North Slope oil development provides a number of examples of so called green solutions which benefit the environment and actually lower development total costs. These include small footprint development and the increased use of directional and horizontal well drilling techniques minimizing surface disruption as well as downhole disposal of drilling fluids.

## Tax costs

Alaska's method of collecting the resource rent from petroleum production is clearly not economically efficient since it relies on levies against gross resource value rather than net resource value. It can very easily be demonstrated in theory that, if the economic rent or net resource value were taxed, Alaska would not only be a more attractive place for petroleum exploration and development but also would generate as a result more resource rent. The theory underlines the trend in most other parts of the world to make the petroleum taxation systems focus on rent taxes rather than excise or production taxes.

Interestingly, with hindsight, Alaska's separate accounting oil and gas corporate income tax was a rent tax. The producers apparently were more willing at the time to get rid of that tax as long as the excise tax rate could be kept down. In practice, even with the fixed royalty and production tax system, Alaska's oil taxes compare favorably with other oil-producing regions of the world in terms of providing oil producers with a sufficient rate of return for the super giant Prudhoe Bay field (Gaffney *et al*). A rent-based tax system would definitely enhance the commercial viability of a number of currently uneconomic discoveries in the Alaskan Arctic.

## Active management of Alaska's royalty oil

Alaska has sold large amounts of its royalty oil to in-State refiners for many years. These sales have a multiple purpose including providing value enhancement and creation of jobs, insuring the availability of petroleum products to citizens, and earning public revenue. The maximization of royalty value has not been a goal. Alaska has specifically attempted to remain a passive rent collector and has not strived to enhance the value of its royalty production. In those few cases in which royalty oil was sold to the highest bidder, the State ended up with a number of deals which were defaulted upon. As a result, royalty value enhancement has not been seriously considered as a viable royalty oil management option.

It has been suggested several times that Alaska could become more active in managing royalty oil for additional return. Alaska could negotiate a sale of its oil for delivery to a lower 48 refinery obtaining valuable information and experience as to the actual costs associated with the business of shipping and selling oil. The State could also do processing deals with lower 48 refiners or other potentially profitable downstream activities enhancing the value of its oil production.

Theoretically there is no reason that the State of Alaska could not establish a quasi-public agency to explore, develop, and market its petroleum resources. In fact most of the oil produced in the world today is produced in countries with national oil companies. Certainly this is the case for OPEC, but also many non-OPEC countries as well. Norway, for example, not only has a national oil company Statoil, but is a shareholder in Norsk Hydro. Net importing countries like the French and Italians also have successful national oil companies.

Alaska does have some additional regulatory power over the rate of production which could theoretically be exercised to enhance royalty values. If the power to regulate oil production to prevent waste were defined to include an economic dimension, then Alaska would have the power to require oil producers to underlift or produce at something less than physical capacity. This is the power which the Texas Railroad Commission used in the 1930s and 1940s to pro rate oil production in Texas to support oil prices. If Alaska had exercised this right in 1986, when oil prices were below $10/b (near $0/b at the wellhead), oil left in the ground could have been sold for $20/b 12 months later.

Alaska, as part of the US, faces very real institutional barriers to this kind of active involvement in the oil business beyond the wellhead. I have attempted to identify some of these barriers as follows:

1. This kind of activity is most often thought to be the purview of the private sector.
2. The disposition of the State royalty oil involves the public right to know the how and what of this disposition. This makes a commercial agreement difficult for negotiating parties, particularly in an environment as competitive as petroleum marketing.
3. The US political system is not well suited to allowing public officials to take market risks with public money.

Facing these kinds of institutional barriers, it seems unlikely that Alaska will ever follow in the steps of other oil-exporting regions of the world by moving beyond the role of rent collector. This suggests that Alaska will continue to maintain its love/hate symbiotic relationship with the oil industry.

## Summary

Alaska has had a long and mutually profitable association with the oil industry. Generally speaking, Alaska's claim on petroleum resource rent initially increased in line with revenue needs. Later, with the discovery and development of the mammoth Prudhoe Bay field, this claim became an issue of fair share. This fair share has informally been defined as one-third of the resource rent.

Because of the generally recognized dependence of much of the Alaskan economy on oil revenues, issues of industry taxation have always been approached in a serious matter by policy-makers. No one in the State wishes to kill the goose that lays the golden egg.

At the same time, however, comparison of how Alaska manages the production of its oil resource with other exporting regions of the world shows that Alaska has the potential for enhancing the value of its oil resources which it is not willing or able to undertake. Alaska has opted to be something less than either a full partner or even a competitor with the oil industry. Alaska has instead opted to be a passive rent collector and regulator.

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*Alaska Department of Revenue. Revenue Sources Book. Spring 1992.*

*Alaska Statute 38.05.180(i). Exploration Incentive Credit.*

*Gaffney. Cline and Associates. Aberdeen University Petroleum and Economic consultants. and Homa Motamen Scobie. International Tax Comparison Study. Prepared for the State of Alaska. March 1990.*

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*Logsdon. Charles L.. "Alaska Oil Production in Perspective". Alaska Economic Trends. Alaska Department of Labour. October 1987.*

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. Pg 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: ______

Pg 20 of 6

| SPEAKER | TAPE# | SIGNIFICANT INFORMATION |
|---|---|---|
| shively | 252 | We have at this point... |
| | 260 | I'm not sure |
| Roke | 262 | 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.... |
| | | started out w/crude from several |
| | 325 | Taps Tariff - 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 | | 60 |

COMMITTEE: ______ DATE: ______ TIME: ______

SUBJECT: ______

MEMBERS: ______

Pg 3 of 6

| 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 | 402 | They have |
| Shive | 405 | I agree.... |
| | | Mr. Chair..... |
| | 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 | 465 | 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 | 580 | let's look at the book... |
| | 561 | what that does is depict the Price.... |
| | 575 | it is a premium because Exxo only ONR's Rationale on this is .... |
| | 585 | Displacement Effect... |
| | 600 | Time was run |
| Navarre | 601 | Mr. Tillinghouse |
| Tillinghouse | 602 | |
| Navarre | 605 | The BP - thats adjustable. |
| Tillinghouse | 610 | It could go either |
| Navarre | 613 | |
| Tilling | 614 | Bear, in Mind. |
| Navarre | 617 | I have a ques |
| Roke | 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 anual fees.... |
| Williams | 683 | is there any other way that |
| Smith | 687 | we have our refinery put up... |
| Tilling | 694 | In addition to the |
| Roke | 697 | Thank you I had. |
| Tilling | | |
| Roke | 700 | we have to wrap it up. |

COMMITTEE: ______ DATE: ______ TIME: ______

SUBJECT: ______

MEMBERS: ______



| SPEAKER | TAPE# | SIGNIFICANT INFORMATION |
|---|---|---|
| Roke | 203 | thanks. |
| Novorre | 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.... |
| Navorre | 055 | I said that theory flawed? |
| Shively | 071 | BP wouldn't ship to the Gulf unless |
| Novorre | 079 | why would you put that on. |
| Shive | | |
| Banks | 087 | focus on Percentages |
| Novorre | 092 | If we take |
| Shive | | Gulf |
| Novore | 098 | We take lowest value oil. |
| Banks | 105 | What has happened... |
| Novorre | 118 | We are, if we take 40,000 barrels |
| | | away from the.... |
| Banks | 135 | Your way of looking at it. |
| | | I'll restate my |
| Novorre | 143 | If Tesoro decided they couldn't |
| | | support this..... |
| Shively | 155 | We are making the Assumption... |
| Novorre | 171 | If you're going to look at this... |
| Shively | 180 | Well, that is correct.... |
| ~~Novorre~~ | ~~197~~ | it is our assumption.... |
| Novorre | 197 | when was |
| Banks | 199 | 192 |
| Novarre | 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 | Thank you, this gives has the |
| | | price & weight.... |
| Shively | 285 | One competitor.... |
| G. Davis | 290 | that's what I mean |
| Shive | | We, Did not... |
| Roke | 293 | 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.

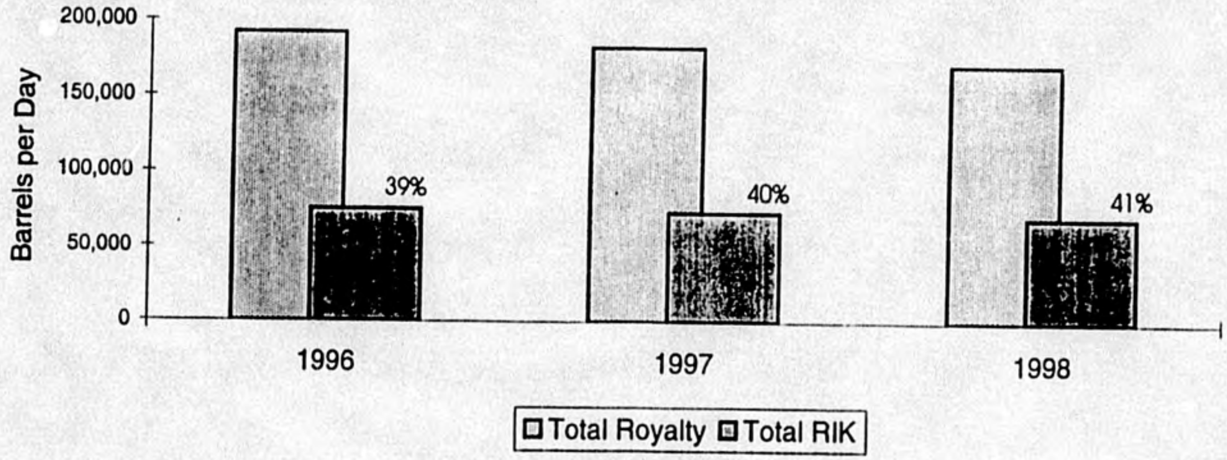
- Air Quality. The sale will not contribute to an increase in emissions at the refinery. Tesoro now operates under ADEC Air Quality Control permits.

- 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)



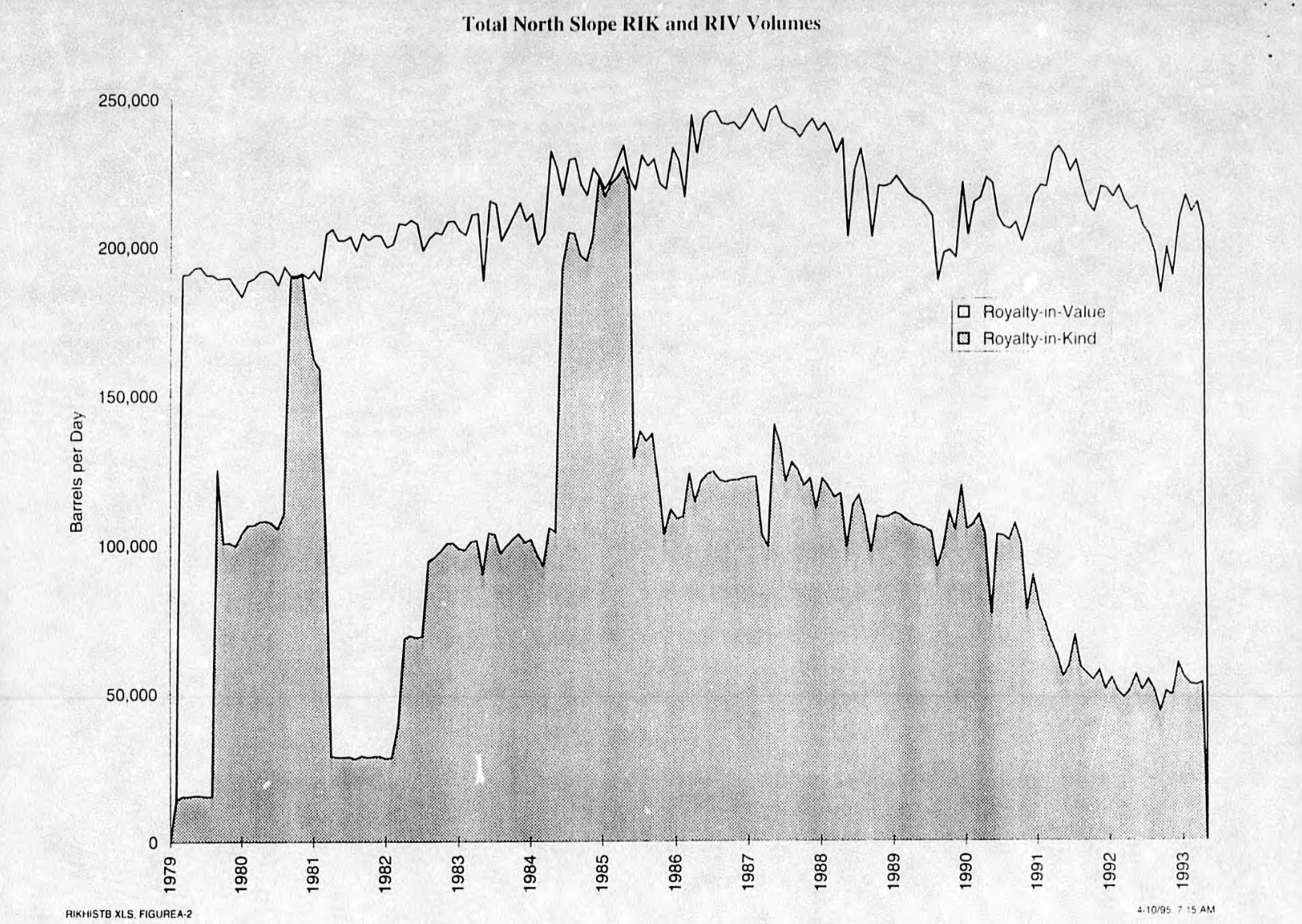

TESORO2.XLS, Chart1

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
250,000
200,000
150,000
100,000
50,000
0
Barrels per Day
Royalty-in-Value
Royalty-in-Kind
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
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 NR
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

**DEPARTMENT OF NATURAL RESOURCES**

*DIVISION OF OIL AND GAS*

*TONY KNOWLES, GOVERNOR*

MAR 30 1995

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


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

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**Preliminary Finding and Determination**

**to Sell Royalty Oil**

**to**

**Tesoro Alaska Petroleum Company**

Alaska Department of
NATURAL
RESOURCES

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

March 21, 1995

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

## I. Summary

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

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

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

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

Fairbanks Office
119 North Cushman
Fairbanks, Alaska 99701-2879

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

Kenai Peninsula Office
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 not 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**

DNR Draft: 03/21/95 9:19 AM

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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.

# CORRECTION

THE FOLLOWING DOCUMENT(S)
HAVE BEEN REFILMED TO
ASSURE LEGIBILITY OR PAGINATION

THE SEAL OF THE STATE OF ALASKA

Rev. 6/98

Central Microfilm Services
Departement of Education
State of Alaska

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