ALASKA LEGISLATURE COMMITTEE FILES 1981-1982 8672

1940 SRES SB 880 - SB 881

Mr. Jurin replied that he didn't know what the future price situation would be; the cost of raw materials is not the only factor. A long-term contract would mitigate abrupt shortages in supply, which have been brought on in the past by economic supply shortages, requiring that Tesoro reduce production runs. Tesoro will do whatever possible to maintain the competitive or below market pricing.

In response to Rep. Halford, Mr. Jurin stated that Tesoro currently supplies 27 to 28 percent of the market directly, with the remainder being supplied by Chevron, Union, Texaco and independent operators. Tesoro will probably never supply the whole state, due to competive differentials in transportation costs. Tesoro serves mainly the lower railbelt and Kenai area. They provide 78 percent of the turbine fuel to the Anchorage International Airport, and will probably supply more with an arrangement for another hydrocracker plant. The potential loss to the state by the west coast offset may change; the gulf coast prices have been traditionally higher that the west coast. Tesoro would not be looking for a long-term contract if they thought that there would be an ample future supply of oil. Projections predict that there will be more shortages than surpluses over the long run.

In response to Rep. Cotten, Mr. Jurin stated that Tesoro has a contract with San Deigo Gas and Electric to purchase the return oil. The contract began in 1972, and has been renewed through 1984. Tesoro intends to expand their facilities to process the return oil. They don't have a guaranteed market in the pipeline.

Jim Smith, President, Tesoro Alaka Crude Oil Company, in response to Rep. Cotten, stated that whether the price Tesoro would pay for oil would be greater than the average weighted price, if they purchased it from a producer other than the state depends upon variable market conditions. Tesoro is currently buying ANS crude from Sohio on the spot market, probably paying more than they would pay other producers, but the other producers are not willing to sell.

The Committee was adjourned at 9:50 a.m.

SB 956 TITLE & SPONSOR SUMMARY

AMENDED TITLE:
AN ACT RELATING TO INTEREST ON DELINQUENT OIL AND GAS PROPERTIES
PRODUCTION TAXES;
AND PROVIDING FOR AN EFFECTIVE DATE

PRIME SPONSOR: SENATE RULES COMMITTEE.
CO-SPONSORS:
CURRENT STATUS: 3/12/82 IN (S) FINANCE

SB 956 SENATE ACTION 08:42 4/02/82 PAGE 2 OF 2

DATE	SEQ	PAGE	LEGISLATIVE ACTION
03/12/82	01	0556	FIRST READING -- COMMITTEE REPORTS FINANCE RULES

**** ** ** **** **** ****

AGO 786163

DOYON LTD. CONTRACT

2.1	Quantity	9.067% of daily royalty oil, approximately 17,000 B/D
2.2	Quality	ANS
2.3	Price	In-value
2.4	Point of Delivery	TAPS meter, Prudhoe Bay
2.5	Passage of Title	Seller tenders oil at point of delivery
2.6	Purchasers' Responsibility	After passage of title.
2.7	Transportation	Purchaser responsible from point of delivery.
2.9	Date of First Delivery	December 1, 1982
2.10	Reservation Fee	Pay 1.25% of purchase price difference between amount taken and maximum quantity.
2.11	In-State Processing	Purchaser agrees to process all oil through refinery near North Pole.
2.12	Best Efforts	Purchaser agrees to use its best efforts to produce and market in Alaska not less than 32% of product tendered.
2.14	Exchange-Return Oil	The amount tendered greater than amount produced - return oil reinjected into TAPS - paying a quality adjustment.
	Note:	Chevron USA still a part of contract (pages 14-15) for disposition of return oil.

ARTICLE III

Good standing - financial condition - financial statements - standard clauses.

3.4	Option to Purchase Residual	State option to purchase all or any quantity of residual oil.
3.5	Petroleum Coke	Doyon agrees if it modifies or expands refinery at North Pole to produce and handle petroleum coke. State option to buy coke.

ARTICLE V

Measurement standards and procedures, payment and accounting adjustments, payment, interest standard clauses.

ARTICLE VI

6.1	Term	December 1, 1994 - 12 years

ARTICLE VII
Default or termination - standard clauses.

ARTICLE VIII
Disposition of oil upon default - inability to receive oil - standard clauses.

ARTICLE IX
Waiver - standard clause.

ARTICLE X
Validity - standard clause.

ARTICLES XI - XIII
Standard clauses.

ARTICLE XV
Security - irrevocable stand-by letter of credit 22,440,000 or approximately 60 days supply of oil.

REMAINING ARTICLES
Preferential hiring, applicable law, warranties, successors, records, interpretation of terms and conditions, standard boiler type clauses.

Alaska State Legislature

SENATE
Resources Committee

Offical Business

BETTYE FAHRENKAMP, Chairman
VIC FISCHER, Vice-Chairman
BRAD BRADLEY
DICK ELIASON
DON GILMAN
BOB MULCAHY
ARLISS STURGULEWSKI

POUCH V
STATE CAPITOL
JUNEAU, ALASKA 99811
(907) 465-3834
(907) 465-3835

MEMBERS PRESENT

Senator Fahrenkamp
Senator Eliason
Senator Gilman
Senator Mulcahy
Senator Sturgulewski

April 7, 1982
3:10 p.m.

Beltz Room
Room 211 - Capitol

Hearing:

SB 880 Sale of royalty oil by the State of Alaska to Doyon, Ltd.
SB 881 Sale of royalty oil by the State of Alaska to Tesoro Alaska Petroleum.

Senator Fahrenkamp explained that the Committee was to either accept or reject the contracts, but could not amend them.

SB 881

Dennis Jurin, President, Tesoro Alaska Petroleum Company, spoke in support of SB 881, stressing that projections predict that over the long run there will be more shortages of oil than surpluses. Although crude oil prices are very difficult to predict even for the short term, Jurin was confident that the selling of oil in kind would not result in depreciation of the State's revenue. He reviewed his company's "good track record" and the direct positive economic impact they continue to have on the state. He concluded by stating his company's need for a long-term, stable supply of crude oil to continue refinery operations.

Senator Mulcahy moved SB 881 and asked unanimous consent.

SB 880

John Katz, Commissioner, Department of Natural Resources, described two items of concern in the Doyon contract. One is the four year waiver on option fees, which is an incentive to new entry but may be anti-competitive. The other is Doyon's lack of financing. Katz suggested that the Committee has three options: to approve the contract, disapprove the contract, or approve the contract contingent on a finding by the Commissioner of the Department of Natural Resources that, by a date certain, financing is firm and adequate, and that all other essential aspects of the program have been maintained.

Tim Wallis, President, Doyon, explained that their financing is contingent on getting rid of the return oil. A contract to this effect needs to be negotiated, and a search for an equity partner completed. He stated that a 6-month period would be "comfortable" for meeting these goals.

Senator Mulcahy moved that Doyon be given until September 1, 1982 to obtain financing, while maintaining all other essential elements.

Senator Mulcahy moved CSSB 880 with individual recommendations.

The meeting was adjourned at 4:00 p.m.

Alaska State Legislature

SENATE
Resources Committee

Offical Business

BETTYE FAHRENKAMP, Chairman
VIC FISCHER, Vice-Chairman
BRAD BRADLEY
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POUCH V
STATE CAPITOL
JUNEAU, ALASKA 99811
(907) 465-3834
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TO: Senate Resources Committee

FROM: Senate Resources Committee Staff

RE: Committee Meeting, 4/7/82

DATE: April 5, 1982

Please find attached background information for Wednesday's hearing on the following bills:

SSSB 796 TELECONFERENCE 1:30 -3:00 p.m.
Providing for the management of state owned land in the Haines area, establishing the Alaska Chilkat Bald Eagle Preserve and the Haines State Forest Resource Management Area.

3:00 - 4:00 p.m.
SB 880 Sale of royalty oil by the State of Alaska to Doyon, Ltd.

SB 881 Sale of royalty oil by the State of Alaska to Tesoro Alaska Petroleum.

The meeting will be held in the Beltz Room.

TESTIMONY OF TIM WALLIS
PRESIDENT, DOYON, LIMITED

ROYALTY OIL CONTRACT
Juneau, Alaska
April 7, 1982

AGO 786197

My name is Tim Wallis and I am president of Doyon, Limited.

Thank you Mr./Madam Chairman and members of the Committee for the opportunity to testify on SB 880 and HB 889 concerning ratification of the royalty oil sales contract between the State of Alaska and Doyon, Limited.

Our contract represents the first concrete attempt by an Alaska-owned company to break into the in-state refining business. As such, the issues inherent in your decision to ratify are straight forward. It is my intent today to provide you with a status report of our project and to answer all your questions. Hopefully, this will assist you in your decision-making process. And, it will assist Doyon in proceeding with the most beneficial project underway in the interior today.

PROJECT STATUS

By way of background, Mr. Chairman, during the past 20 months, Doyon has been actively investigating various oil and gas projects in order to find a way to minimize the impact of fuel costs to residents throughout the interior region of Alaska. Our investigations and studies have included new refineries at the Yukon River, Valdez, Fairbanks and the Lower 48. We investigated acquiring existing refineries. We've conducted detailed feasibility studies on methane distribution for Fairbanks and we've advanced what we view as the only common sense approach to moving natural gas liquids from Prudhoe Bay to processing sites in Alaska. It was not without considerable preparation that we committed to the present refinery project at North Pole.

In November, 1981, Doyon, Limited signed a lump sum, turnkey contract with Litwin Engineering and Constructors for construction of a distillation refinery with a throughput of 30,000 to 35,000 BPD. Furthermore, the key components, i.e., crude tower and furnace, are sized for 50,000 BPD. The product slate will be JP-4, commercial jet fuel, gasoline, home heating oil and diesels. The economic feasibility of the project is in large part based upon the absence of gasoline manufacturing north of the Alaska Range, and small business set asides for certain Defense Fuel Supply Center contracts, especially JP-4. In addition to these key product markets, Doyon anticipates capturing a modest share of the other refined product markets.

The project was scheduled for fast track completion in December, 1982. However, primarily due to Chevron USA and the state not reaching an agreement on the return oil, and rapid readjustment of crude supply prices, we have rearranged the priorities of the tasks to complete the project by assigning priority to the sale of the return oil from the refinery. This rearrangement is partly dictated so that long-term financing can be negotiated under such advantageous terms as will benefit Doyon and our customers.

Engineering and design are 90% complete. Doyon presently owns all of the key refinery components which are, for the most part, skid mounted and ready for shipment to Alaska. Doyon also owns the refinery site, a 75-acre tract at North Pole, adjacent to the trans-Alaska pipeline and an existing refinery. All work has been completed for environmental permits. The final air permit is expected to be issued in the next 10 days. This represents a substantial investment by Doyon and a strong financial commitment to the project.

GENERAL CONCERNS

During the period of time from November, 1981 through February, 1982, Doyon negotiated with the Department of Natural Resources to arrive at the contract that is before you.

CHANGED CIRCUMSTANCES

It cannot be over-emphasized that Doyon plans to proceed with its refinery project. When we signed the royalty contract on February 26, 1982, our completion date was December, 1982. Now it is June, 1983 -- an 18-month construction schedule instead of the fast tracked 12-month schedule. On March 6, it was reported that we put the project on "hold." This was a poor choice of words. It has been interpreted to mean that we stopped all work on our project when in fact we have not. We simply changed emphasis on the tasks needed to complete the project. Even at this moment, work is being completed on the reformer, heat exchangers and crude skids which include the main processing unit. A better choice of words would have been that our change in emphasis necessitated an extension of the schedule for project completion from December until June. The change of emphasis resulted from various circumstances.

Foremost, our contract was predicated on the Department of Natural Resources' desire to sell our return oil to Chevron. By the time we learned that the Chevron contract would not be signed, the world oil surplus and rapid price decline made it much more difficult to sell the return oil.

Consequently, Doyon is presently negotiating with several companies to sell the return oil. But because [illegible] are dealing in a current "buyer's market," it is more difficult than it was six months ago.

The return oil and the state contract are the most important factors in financing our project. In order to successfully negotiate the sale of the return oil, it is imperative that we have it to sell. This is why any suggestion that the contract not be approved until financing is in place is a Catch-22 situation. The fact is that the contr[illegible] requires Doyon's refinery to be operational by December, 1983. Nothing has changed to prevent Doyon from complying with this requirement. For the aforementioned reasons, we've slipped the schedule to a more nearly normal time line. And this time line is within the scope envisioned in the contract.

It appears that the length of the construction schedule is being confused with the depth of commitment Doyon has made [illegible] the refinery. We should not be penalized for not meeting [illegible]t track schedule that was achievable only if all things fell into place, including the sale of return oil.

In summary, Mr. Chairman, it is the nature of projects of this magnitude that all of its elements are interdependent. Financing is dependent on cash flow. Cash flow is dependent on sales contracts. Sales contracts are dependent on supply contracts. They are all dependent on a business organization with the skill to unify the diverse requirements for each element. The absence of any one element only serves to make achievement of the other elements more difficult. If the royalty oil contract is not approved and deferred until next year, then it may be impossible to complete the other interdependent elements. It costs the state nothing to approve the contract, but dis.pproval may cost the people of the state all that could be gained from a competitive Alaskan-owned refinery.

In keeping with the legislature's and administration's policy to encourage in-state use of royalty oil, I request your approval and passage of H.B. 889 and/or S.B. 880.

RESULTS OF ROYALTY BOARD MEETING MARCH 23rd

1:30 - 4:30 p.m.

SB 880/881

keep w/ oil contract stuff in gov. files

1. Doyon withdrew contract #2

2. Doyon contract #1

Disapproved because:

1. Refinery financing not in place at this time-
think instate refinery is in the best interest
if and when financing in place would approve
contract.

2. If contract approved the waiver of the reservation
fee would not be acceptable (Sec. 2.10, Page 8)

Note: 1. Av Gross wants the contract approved subject to
Doyon putting in place financing - let the legislature
track progress in next 3 weeks.

2. Katz - wanted to waive reservation fee for 4 years -
give Doyon some marketing equality with Mapco.

3. Approved Tesoro contract for 12 years.

4. Due to non-agreement on pricing the Chevron contract will
not be coming forth.

AGO 786205

ALASKA ROYALTY OIL AND GAS DEVELOPMENT ADVISORY BOARD

Resolution 82-2

WHEREAS, the State of Alaska, through the Commissioner of the Alaska Department of Natural Resources, and Doyon, Ltd. have entered into an "Agreement for the Sale and Purchase of Royalty Oil" dated the 26th day of February 1982; and

WHEREAS, in accordance with AS 38.06.055(a) ". . . 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. . ."; and

WHEREAS, according to AS 38.06.055(a), ". . . a sale, exchange, encumbrance, 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 may not be made by the commissioner of natural resources under AS 38.05.183 without prior review of the proposed sale, exchange, encumbrance or other disposition by the board. A written recommendation of the board on the proposed sale, exchange, encumbrance 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 shall be submitted to the legislature at the time a resolution approving the proposed sale, exchange, encumbrance or other disposition is introduced in the legislature"; and

WHEREAS, in accordance with AS 38.06.040(a), the board shall (2) "hold public hearings on proposed sales, exchanges, or other disposals of royalty oil or gas to determine whether the proposals comply with AS 38.05.070;

AGO 786206

(3) examine proposed sales, exchanges or other disposals of, and recommend to the legislature that it approve or disapprove a proposed sale, exchange or other disposal of

(A) the oil or gas that is obtained by the state as royalty under AS 38.05.182; or

(B) the rights to receive future oil or gas production under state leases"; and

WHEREAS, the board did, on February 26, 1982, meet and receive from the commissioner of natural resources the above mentioned agreement with Doyon as well as a document entitled "Review of Alaska Royalty Oil Policy and Findings on Proposed Disposal of State Royalty Oil" dated February 26, 1982 and the board did act and call public hearings, in accordance with the regulations outlined 3 AAC 56, in Anchorage on March 15, 1982 and Fairbanks on March 16, 1982 and received public comment pertinent to to this agreement; and

WHEREAS, in accordance with AS 38.06 and AS 38.05, the commissioner of natural resources is required to submit to the board, in writing, certain Findings or Determinations relating to the disposal of oil and gas royalty interests and the board has received the required Findings and Determinations; and

WHEREAS, the board members have had the opportunity to review the agreement, related Findings and Determinations and Public Testimony during the period February 26, 1982 until March 25, 1982; and

WHEREAS, the board did, on March 25, 1982, meet to discuss the agreement, related Findings and Determination, and Public Testimony to insure that this disposal is in accordance with the statutory purpose and criteria set forth in AS 38.06 as well as the board's "Basic Principles and Policies" as outlined in the board's development plan, and

THEREFORE, the board finds as follows:

1. that the commissioner of natural resources has followed the board policies and applicable statutes and regulations relating to the disposal of oil and gas royalty interests.
2. that the board favors increased in-state use of its royalty interests such as construction of a new refinery.
3. that the board disagrees that the sale of the royalty oil interests to Doyon, Ltd. as per the agreement is in the best interest of the state because

   (a) that financing and therefore timing of the ~~the board believes it to be unlikely that a second~~ proposed project is currently uncertain and it is ~~refinery located in the Fairbanks area is economically~~ not in the state's best interest to conclude a ~~viable.~~ contract until the project is ready to move forward.

   (b) ~~Doyon has not made any attempt to demonstrate that~~ The provision for delayed payment of the reservation ~~the new refinery is feasible.~~ fee according to paragraph 2.10 of the contract

   ~~(c) Doyon admits that the proposed project is currently~~ creates an unacceptable bias against competitors. ~~on "hold".~~

   ~~(d) the board believes that when Doyon is ready to proceed with the project that they should request royalty oil if it is in their interest.~~

AND THEREFORE BE IT RESOLVED THAT the Alaska Royalty Oil and Gas Development Advisory Board recommends to the Twelfth Alaska Legislature that the "Agreement for the Sale and Purchase of Royalty Oil" between the State of Alaska and Doyon, Ltd., dated February 26, 1982 be DISAPPROVED.

Board Member ______________________________ moved the adoption of the Resolution. Board Member ______________________________ seconded. The vote was as follows:

AGO 786208

APPROVE

DISAPPROVE

Adopted this 25th day of March 1982.

R.A. Lyon

Chairman

SB 880

MEMORANDUM

State of Alaska

TO: Members of the Alaska State Legislature

DATE: March 10, 1982

FILE NO:

TELEPHONE NO:

MAR 15 1982

FROM: JWK
John W. Katz
Commissioner
Department of Natural Resources

SUBJECT:

A formal introduction of the State's proposed royalty oil sales contracts must await the hearings and review by the Alaska Oil and Gas Development Advisory Board. That review should be concluded March 26, 1982. In the meantime, we would like to present you with sufficient information for you to begin your consideration of the proposed contracts.

The State, acting through the Commissioner of Natural Resources, has entered into contracts with Tesoro Alaska Petroleum and Doyon, Ltd. A conceptual agreement with Chevron, U.S.A. has also been proposed, but the agreement has yet to be finalized. Still under consideration are two other proposals: an offer by Suneel for 15,000 barrels per day of royalty crude to use as an exchange for petroleum coke needed to blend with Alaskan coal and an offer by Provident/ Kodiak Industries Corp. to purchase royalty crude at a premium price for export to an Arizona refinery. Contracts with Suneel and Provident/Kodiak Industries have not yet been negotiated and may, or may not, ever be finalized.

The attached paper discusses in greater detail the proposed contracts, possible effects of in-kind sales on Alaska's revenues, and general policies and procedures used during the solicitation process. A much more detailed discussion can be found in the Commissioner's Findings of February 26, 1982, which we will make available to you upon request.

I hope that this memorandum proves useful as you begin your deliberations on the proposed contracts. I will be glad to respond to any questions or requests for further information.

Attachment

AGO 786210

02-001A(Rev.10/79)

SUMMARY OF PROPOSED DISPOSITION

OF ROYALTY OIL

Department of Natural Resources
Commissioner's Office

March 15, 1982

I. Summary of Proposed Contracts

TESORO ALASKA PETROLEUM

The contract with Tesoro Alaska Petroleum is for the sale of 24.533% of the State's prudhoe Bay royalty oil (about 46,000 b/d) for a 12 year term at the in-value price. Tesoro is required to process the royalty oil in its Nikiski refinery and use its best efforts to market the products in-state. Exchanges of royalty oil for other crude (recognizing the limited ability of its refinery to run ANS crude) is permitted provided the exchanges are of equal value. Deducted from the 46,000 b/d is the amount of Cook Inlet royalty crude Tesoro receives at any time from its existing contract with the State. Tesoro agrees to continue to evaluate the possibility of expanding its refinery, including the construction of petroleum coking capacity. The State retains an option on all residual oil products (including any petroleum coke) produced from the Nikiski refinery. Tesoro may vary the volume taken at any time up to the maximum volume, but pays a reservation fee on the portion unused. The contract may be terminated on nine months' notice by Tesoro.

DOYON LTD

The State has executed two separate and mutually exclusive contracts with Doyon Ltd. Doyon contract #1 is for the sale of 10.677% of the State's Prudhoe Bay royalty production (approximately 19,000 b/d) for a 12 year term at the in-value price. Deliveries of any oil under this contract are contingent on the construction of a major new refinery at Fairbanks by December of 1983 and the marketing of products therefrom. If the refinery is not operating by that time, the contract automatically terminates. Doyon is required to process the royalty oil at the Fairbanks refinery and to use its best efforts to market the products in-state. The State retains an option on all residual products. Doyon may vary the volume taken up to the maximum volume, and may terminate the contract on nine months notice. The reservation fee system, a common feature of all the contracts, is deferred for four years as a concession to Doyon's status as a new refinery entering an existing market. The 10.677% figure represents the net barrels retained by Doyon from processing the maximum royalty oil which can be run through the facility (around 48,000 b/d), on the assumption that the State will take back the return oil and resell it to another Purchaser (Chevron). If the State does not take the return oil, the sale would be for 26.667% (the full refinery charge), and Doyon would be responsible for disposing of the return oil.

AGO 786213

In the event Doyon acquires a controlling interest in the Mapco refinery prior to May 1, 1982, Doyon contract #1 goes out of existence and the Doyon contract #2 continues. If Doyon should acquire Mapco's plant at a later date, it must elect to either continue Doyon contract #1 or take the existing Mapco contract. However, Doyon may take the Mapco volume under the Doyon contract #1 (with the maximum volume not to exceed its total Fairbanks refining capacity) under limited circumstances, but it must still build a new Refinery.

Doyon contract #2 is for the sale of 9.067% of the State's Prudhoe Bay royalty production (about 17,000 b/d) for a 12 year term at the in-value price, on the assumption that Doyon acquires a controlling interest in the Mapco refinery and contract prior to May 1, 1982 (in which case the Doyon contract #1 expires). The volume sold under this contract, when combined with the volume committed under the existing Mapco contract, equals the gross refinery charge of the existing Fairbanks refinery. The concessions granted Doyon under contract #1 in recognition of their status as a new entrant are not included in contract #2 since they would be supplanting Mapco as the owner of the existing Fairbanks refinery. The State retains an option on all residual products, and has an opportunity to gain access to the return oil for resale to a downstream purchaser.

CHEVRON U.S.A.

A contract has not yet been consummated by the State with Chevron USA. However, the State has made a firm offer to Chevron for the sale of 20.267% of the State's Prudhoe Bay royalty oil (about 38,000 b/d) for 12 years at the in-value price. About 18,000 b/d would be processed at Chevron's Nikiski refinery, yielding a specified level of products (including asphalt) which Chevron must use its best efforts to market in-state. The other 20,000 b/d would be processed by Chevron in California and returned to Alaska as finished products in the form of a specified products slate (including aviation gasoline).

Chevron would be required to evaluate both expansion of its Nikiski refinery and its products handling and marketing facilities in Western Alaska. In the case of a West Coast crude shortage, Chevron would have to meet Alaska product requirements first. Chevron would also have to continue to supply at competitive prices all local Alaska markets in which it is the sole supplier. Further, Chevron would grant to the State an option to purchase up to 400,000 tons annually of petroleum coke. If the coke was unavailable because of existing contractual commitments, Chevron would be required to assist the State in locating other supplies. The option would be assignable by the State to a bonafide exporter of Alaska coal.

Other provisions of the Chevron contract are similar to the Tesoro contract.

Still Under Consideration:

SUNEEL ALASKA

Suneel Alaska has requested up to 15,000 b/d of royalty oil for 10 years to be used to exchange for petroleum coke for blending with Alaska coal exported to Korea from the Usibelli Mine in Healy. The Department is determining whether a sale of royalty oil to Suneel is necessary and in the State's interest, or whether enhancement of Alaska coal exports can more practicably be served by the reservation of an option by the State on petroleum coke from another party (assignable to any Alaska coal exporter) or by other arrangements for procuring supplies.

PROVIDENT/KODIAK INDUSTRIES

Provident has requested up to 50,000 b/d for 20 years to be used in a refinery to be constructed in Arizona. No interim taking is requested, and Provident has offered the in-value price plus a potential profit share to the State based on refinery profitability. In addition to assessing the likelihood of success of a sophisticated and expensive new refinery in a somewhat isolated market and the methods of financing the refinery, the Department is also reviewing the profit share mechanism. Since this is an export contract, it is not in the State's interest to make the sale absent a substantial premium. Futhermore, the State must assess the potential adverse market effects of a sale of this nature.

II. Solicitation and Royalty Oil Available

The initial solicitation for this disposal was issued on February 6, 1981, and was later amended on July 31, 1981. The solicitation requested proposals to purchase royalty oil for in-state processing, in-state supply of petroleum products, or other proposals in the best interests of the State. Twenty-seven companies responded prior to the September 1, 1981 deadline. The proposals generally fell into three categories: in-state processing, export with supply of products back to the State, and strictly export (in some cases with ancillary benefits to the State).

All of the State's royalty oil from Prudhoe Bay and Kuparuk (approximately 197,500 b/d at current production levels) was available for sale through this solicitation except for the 15% of State royalty production committed to Mapco Alaska and Golden Valley Electric Association under their 1978 contracts. Cook Inlet royalty crude oil is committed to Tesoro Alaska Petroleum (approximately 9,000 b/d). The statutes governing royalty oil sales are AS 38.05.182-183 and AS 38.06.

III. Procedures

Initial meetings were held with each company in October to review their proposals. Letters were sent to each company setting forth the basic criteria to be used by the State in evaluating proposals. The State also revised its standard royalty contract and invited each proponent to make recommendations on that contract, including the price term mechanism. After consultation with the Royalty Board, an initial round of eliminations took place in which the proposals of the following companies were rejected: A Ruddy Petina Oil Company, Alaska Interior Resources Company, Alaska Oil Company, American Mining and Manufacturing Corp., Amoco Supply and Trading Company, Arco Petroleum Products Company, Ashland Petroleum Company, Exxon Company, Koniag, Inc., and Sohio Alaska Petroleum Company.

Negotiations continued through December and January. During the course of the negogiations, the following companies withdrew voluntarily from further consideration: Alaska Pacific Oil and Refining, Amerada Hess, American Mexican Petroleum Corp., Dow Chemical Company, Northwest Holdings, Nikiski Offshore, Sealaska, Tanana Valley Refining, Tosco Corporation and Union Oil.

In addition, mutually satisfactory agreements could not be reached with Mapco Alaska and Shell Oil Company.

The Department consulted with the Royalty Board at each critical stage of the negotiations.

The Department has submitted three contracts to the Royalty Board as of February 26, which will be forwarded to the Legislature with the Board's recommendation after public hearings are conducted on March 15-16. One of the contracts is with Tesoro Alaska Petroleum and two are with Doyon, Ltd. Negotiations are continuing with Chevron USA, and an agreement with Chevron may be forthcoming during this legislative session. The Department is still continuing discussions with Suneel and with Provident/Kodiak Industries, but has not yet determined whether a sale to either of those parties is in the best interest of the State.

All of the procedures, policies, and information utilized in arriving at decisions under this solicitation are documented in a 238 page Finding issued by the Commissioner on February 26, 1982, and presented to the Royalty Board.

IV. Effects of In-Kind Sales on State Revenues

In conjunction with this disposition, the Department reviewed the workings of domestic and crude oil markets to more fully understand the context in which State royalty oil sales would be made. This review of the market factors affecting the value of Alaska North Slope crude verified that the in-kind taking of royalty oil (as opposed to leaving it in-value with the North Slope producers) may have a significant adverse impact on the State of Alaska's revenue receipts in the form of lowered royalty payments and severance taxes.

The basis for the calculation of State severance taxes and royalty receipts is the price received by the North Slope producers for all of the ANS crude they market. Transportation charges and pipeline tariffs are subtracted from the destination sales price, leaving a "netback" or "wellhead" price; the results are averaged for all producers by volume, yielding a weighted average field price upon which the calculations are made. If the State leaves its royalty oil in-value to be

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marketed by the producers, their disposition of royalty oil is included in the calculation. Conversely, any royalty oil taken in-kind by the State is deleted from the calculation of the weighted average field price.

ANS crude oil is sold by the producers both in the West Coast and Gulf Coast markets; about 850,000 b/d of the 1,600,000 b/d of ANS currently being produced goes to the West Coast, with the remainder marketed in the Gulf. The factor which impacts State revenues stems from the different characteristics of the West Coast market, which have traditionally caused the netback price from West Coast sales to be significantly higher (as much as $3 per barrel) than for sales in the Gulf of Mexico. Consequently, West Coast sales by the producers generally yield higher wellhead values (and therefore higher royalty and severance tax payments) than sales in the Gulf Coast.

If the State takes royalty oil in-kind and makes sales which displace West Coast sales by the producers (which may often be the case for sales to in-state refiners and suppliers), the effect is to delete a substantial volume of the higher netback West Coast sales from the calculation of the weighted average field price, thereby lowering that average and the amounts received by the State in royalty and severance tax payments. Were the State to take all of its nearly 200,000 b/d in-kind and make sales comprised entirely of West Coast placements, the State could lose in excess of $10 million annually at the current West Coast/Gulf Coast netback price differential.

There are, however, several factors which mitigate against this potential loss. First, the State is not proposing to take all of its royalty oil in-kind, but rather a maximum of about 130,000 b/d out of its 197,500 b/d total. Second, not all of the barrels sold pursuant to the contracts resulting from this solicitation would be likely to displace West Coast sales by the producers. Third, there is no guarantee that the West Coast/Gulf Coast netback differential will persist, and several prospective changes in market characteristics may at least cause the gap to narrow. Fourth, to the extent royalty oil sales to in-state refiners perpetuate their existence, economic benefits from the operation of said refineries tend to offset any loss. Nevertheless, this is a very significant consideration in assessing the State's interest in making royalty oil sales; absent the statutory preference for sales to in-state refiners and suppliers, the contracts which the Department would be presenting to the Legislature might well be different.

Two other consequences of the West Coast/Gulf Coast netback price differential deserve mention.

First, while the State always receives the legally preferred in-value price for its royalty oil, purchasers of State royalty oil get a significant price break over their other alternatives. The in-value price (i.e., the weighted average price of all producer sales) is a mixed-market price (West Coast and Gulf Coast). Because of the West Coast/Gulf Coast netback price differential producers' West Coast commercial prices tend to be higher than the weighted average field price upon which the State bases its contract price term. As a result, an in-state refiner/supplier or other royalty oil purchaser may obtain ANS crude oil for substantially less (possibly in excess of $1 per barrel) than it would have to pay if it were purchasing from one of the producers. This explains the significant interest in purchases of State royalty oil by all types of companies even in times of plentiful supplies of crude oil.

Second, an export sale of royalty oil to a reseller (i.e., a company with no West Coast refining capacity) places that party in the position of having to essentially outmarket the North Slope producers in order to profit on the resale. If adverse market circumstances place the reseller in the position of having to make distress sales (as may have been the case in 1980 for Alaska Oil Company and several of the State's royalty auction purchasers), a destructive and illogical price war may ensue which can adversely affect the West Coast/Gulf Coast netback differential, as well as ANS prices generally, thereby lowering the State's royalty and severance tax payments. Therefore, the State must be very cautious in making sales to resellers and should not consummate transactions purely for export absent a substantial price premium, if at all.

The foregoing market factors and implications with respect to State finances are discussed in greater detail in Part V(H) and Part VI(A) of the Findings document.

V. Policies on Disposition of Royalty Oil

After review of market factors, governing statutes, the various proposals submitted, and other matters affecting the State's interest, the Department adopted the following policies with respect to dispositions of royalty oil under the current solicitation.

1. Despite the potential adverse financial consequences from in-kind takings discussed under the previous section, it was determined that the preferences for in-state refining and supply contained in the royalty statutes (AS 38.05.182-183; AS 38.06) took precedence over those considerations. Consequently, this solicitation was approached as an oppor-

tunity to satisfy requirements of in-state refiners and to entertain responsible proposals from in-state suppliers. Concurrently, it was considered that strictly export contracts are not expressly favored by the statutes and that absent a substantial premium or other valuable consideration, they are not in the State's interest.

2. The possibility of a sale to the Strategic Petroleum Reserve (SPR) was explored, but mutually divergent economic objectives precluded an agreement at present. The potentiality of the Federal Government lifting the restriction against foreign export of ANS crude was considered to be sufficiently remote to render unnecessary any preparatory actions based on that contingency.

3. The Department recognized the State's sometimes conflicting role as a government and as an oil marketer. The negotiations were substantially complicated because of the Department's desire to achieve procedural equity and substantive consistency in approaching the proposals. Concurrently, the State attempted to remain market neutral in the negotiations because of the competitive relationship between many of the proponents. The position taken by the Department on a common issue was the same with respect to all similarly situated parties.

The only exceptions were directed towards the Doyon proposal, where the Department believed that enhanced competition from a new entrant in the refining business warranted some concessions to provide them with a realistic opportunity to compete. Other in-state refiners have received similar treatment during their break-in period.

4. The Department agreed to become the 100% supplier of crude oil to in-state refiners given sufficient contractual guarantees regarding in-state processing and marketing of crude oil products. However, in view of the demand for royalty oil during this solicitation, the Department was constrained to limit sales to amounts which could be processed in existing facilities. Sales for new refineries or expansions of existing refineries were considered only where a company had made a firm commitment to undertake the new facility or expansion.

5. The Department attempted to limit the term of any contracts to 8 years (the beginning of Prudhoe Bay decline). Because of amortization requirements for the proposed new Doyon refinery, the maximum term was extended to 12 years (estimated as the earliest date at which Prudhoe decline might cause West Coast supply shortages, at which point a maximum range of options with respect to royalty oil disposition will be imperative). Requests from various pro-

ponents (including Doyon) for contract terms ranged up to 20 years or more.

6. The Department carefully reviewed alternative pricing mechanisms to determine if some of the undesirable side effects of using producers' reported prices as the basis of the price term could be avoided. It was readily apparent, however, that shifting to a different mechanism was fraught with risks to both the State and its royalty oil purchasers, and that the existing mechanism was preferable. This view was confirmed by the comments solicited by the Department from prospective purchasers on alternate pricing mechanisms. The Department concurrently determined that there are no circumstances under which the State's interest would be served by a sale of royalty oil for less than the legally preferred in-value price. However, the Department did not request a cash premium from any in-state refiner or supplier.

7. The Department recognized that the State of Alaska is one of the very few politically stable sources of long term crude oil contracts anywhere in the world. Consequently, the State must be wary of vague or impractical proposals underlain by a primary interest simply in obtaining a crude supply or using that supply to finance a development project. Therefore, the Department notified all purchasers that no

crude oil would be delivered until the processing facility or other proposed use was completed; interim taking pending construction of a project (such as in the case of the Alpetco contract) would not be allowed. Calls on future royalties, also a feature of the Alpetco contract, were similarly excluded.

8. The Department attempted to avoid complicated performance benchmarks such as those in the Alpetco contract which were the source of misunderstanding and controversy; instead, relatively simple and concise standards were employed. Since interim taking is not allowed under any contract, the benchmark issue is minimized further.

9. While the Department agreed to supply in-state refiners with the maximum volume which could be run through their facility, it also responded to their request that they not be required to take the full volume at all times if market circumstances dictated otherwise. In return for the fact, however, that the maximum volume would legally be committed to the purchaser for the entire 12 year term (severely limiting the State's flexibility to devote temporarily unused volumes to other purposes), an option fee is charged to a purchaser on the difference between the maximum contract volume and the volume actually being taken at a given time.

10. The Department attempted to use the current solicitation to maximize benefits to the State through several proposals rather than concentrating on a single large scale project. While it would have preferred to have consummated more agreements than has been the case, current depressed market conditions provide scant margins within which to negotiate. mutually beneficial transactions. However, contracts are being submitted for Tesoro (an in-state refiner) and Doyon (a new entrant in the Alaska refining business) to complement the existing contract with Mapco, also an in-state refiner. If an agreement is finally reached with Chevron, contracts will exist with all present and immediately prospective Alaska refiners.

11. The Department sought from each prospective purchaser possible avenues for reducing the burden of high fuel costs in rural (especially Western) Alaska. It became evident, however, that these high costs are primarily attributable to the actual expenses incurred in handling and distributing individual cargoes of crude oil products to numerous small localities under adverse conditions, and that prices could not be substantially reduced absent a direct subsidy. Enhanced competition among refiners and in-state suppliers coupled with lowering crude oil costs should bring some relief to Western Alaska in the immediate future, however.

12. Because of the interest in enhancing exports of Alaska coal through the use of petroleum coke, the Department sought options from all parties on residual products and any petroleum coke produced by that party from its refining facilities. It would be the Department's intention to make the option available to any bonafide exporter of Alaska coal.

13. Finally, the Department reviewed and revised its standard royalty oil contract both to protect the State's interest (reflecting some past experiences with royalty sales) and to achieve basic fairness. In addition, the Department endeavored to approach all proponents on the basis of commercial realism and to avoid asking purchasers to undertake obligations which would be contrary to rational business principles.

TO: Billy Berrier
Director
Legal Services

DATE: 4/7/82

FROM: Bettye Fahrenkamp
Chairman

RE: FINAL Committee Substitute for SB 880

The Committee would like a final Committee Substitute for SB 880 incorporating the following new section:

Page 1, line 28:

"Sec. 2. The Commissioner of the Department of Natural Resources shall make a final decision on the contract by September 1, 1982, based upon Doyon, Ltd. securing financing and maintaining all other elements of the contract."

Please renumber the following section accordingly.

If you have any questions please contact Resa King at 465-3334. When the bill is completed please return it to Room 211 Capitol Building.

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SB884

A REVIEW OF PETROLEUM REVENUES DEPARTMENT OF REVENUE DEPARTMENT OF NATURAL RESOURCES ALASKA OIL AND GAS CONSERVATION COMMISSION

August 15, 1981

Audit Control Number
04-032-0030-R

Commissioner, Department of Revenue	Thomas K. Williams
Commissioner, Department of Natural Resources	John W. Katz
Chairman, Alaska Oil and Gas	Hoyle Hamilton

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

AUDIT DIVISION
POUCH W—ALASKA OFFICE BUILDING
JUNEAU, ALASKA 99811

October 1, 1981

Members of the
Legislative Budget and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

A REVIEW OF
PETROLEUM REVENUES
DEPARTMENT OF REVENUE
DEPARTMENT OF NATURAL RESOURCES
ALASKA OIL AND GAS
CONSERVATION COMMISSION

August 15, 1981

Gerald L. Wilkerson

Gerald L. Wilkerson, CPA
Legislative Auditor
Division of Legislative Audit

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PURPOSE OF THE REVIEW

In accordance with the provisions of Title 24 of the Alaska Statutes a review was conducted to determine the adequacy of internal controls over petroleum revenues. Criteria for the review included:

1. Compliance with the thirteen recommendations from our 1979 audit.

2. The appropriateness of contractual arrangements between the State and purchasers of royalty oil and/or gas.

3. The accuracy and timeliness of in-value and in-kind royalty payments.

4. The Division of Petroleum Revenue and the Division of Minerals and Energy Management's current and proposed policies and procedures for accounting for oil and/or gas revenues.

5. The effect of current and potential litigation on the oil and/or gas revenues accruing to the State.

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ORGANIZATION AND FUNCTION

Responsibility for collection of oil and gas revenues by the State of Alaska is divided between two departments: the Department of Revenue, and the Department of Natural Resources. The Alaska Oil and Gas Conservation Commission provides assistance to both departments by validating production volumes of oil and gas.

The functions of the two departments and the Commission are delegated as follows:

Department of Revenue, Division of Petroleum Revenue is assigned authority under Title 43 to administer the following taxes:

AS 43.55 Oil and Gas Properties Production Tax.

These taxes are computed and assessed as the larger of a "percentage tax" or a "cents-per-barrel tax". The current percentage is 12.25%, or 15% depending on when the well began producing, of the gross value at the point of production of taxable oil and 1 % for taxable gas. The cents-per-barrel is .60 cents for "old oil" and .80 cents-per-barrel for all other oil. The cents-per-thousand cubic feet of gas rate is currently .64 cents. Administration of production taxes is described in the agency's budget requests as through the performance of field audits at Alaskan production facilities, plus periodic home office audits of the various oil companies reporting production in Alaska.

AS 43.56 Oil and Gas Exploration, Production and Pipeline Transportation Property Taxes.

Taxation is accomplished through appraisals and audits of property in Alaska used for the exploration, production of, or pipeline transportation of, gas or refined oil.

AS 43.21 Oil and Gas Corporate Income Tax (effective July 9, 19'8).

This is a new application of the Alaska Corporate Income Tax for firms producing or transporting oil or gas in Alaska. The Division of Petroleum Revenue plans to administer this tax through desk and home office audits.

Department of Natural Resources, Division of Minerals and Energy Management (DMEM) is assigned responsibility for administering oil and gas leases and royalties derived therefrom. Current producing leases allocate 12.5 percent of the oil/gas produced to the State. The State has the option of accepting the wellhead value of the commodity from the producer or accepting the oil/gas itself. Royalty on oil production from the Cook Inlet leases is currently taken in-kind and sold to Tesoro Alaska Petroleum Corporation. Gas from the North Cook Inlet field is taken in-kind and sold to the Alaska Pipeline Company. There is also an agreement with Phillips Petroleum Company, the producer, under which Phillips agrees to purchase any gas not taken by Alaska Pipeline Company, at a price established by Phillips.

At present, royalty on Prudhoe Bay oil production is split between in-value and in-kind. Approximately 7.0 percent of the total net production (total oil production, less topping plant, less wastes, plus gas liquids), is taken in-kind. The remainder of the 12.5 percent royalty is taken in-value. Subsequent to June 30, 1981, the in-kind royalty share will increase to approximately 99 percent.

Alaska Oil and Gas Conservation Commission is an independent quasi-judicial agency of the State formed January 1, 1979. The Commission adminsters the functions formerly delegated to the Division of Oil and Gas, within the Department of Natural Resources. Under Title 31, the Commission is responsible for conservation of oil and gas in the State. The Commission, through the technical expertise of their staff, assists in the collection of petroleum revenues by inspecting and verifying the accuracy of meters used to measure the volumes of oil produced in the State.

FINDINGS AND RECOMMENDATIONS

Recommendations No. 1 through No. 3 are addressed to the Department of Revenue, Division of Petroleum Revenue; No. 4 through No. 12 are addressed to the Department of Natural Resources, Division of Minerals and Energy Management; No. 13 is addressed to both the Division of Petroleum Revenue and the Division of Minerals and Energy Management; No. 14 is addressed to the Alaska Oil and Gas Conservation Commission.

Recommendation No. 1

Oil and gas production tax auditing should be expanded to include more detailed verification.

Recommendation No. 1 of the 1979 review conducted by us stated that the Division of Petroleum Revenue should conduct audits of producer's accounting records to verify the accuracy of information submitted on oil and gas production tax returns.

Since that time, the Division of Petroleum Revenue has performed income tax and production tax field audits of producers which, as of June 30, 1981, have resulted in 22 assessments totalling approximately $16 million. In the course of these audits the Division has relied primarily on producer prepared information, and to a lesser extent on detailed tests of transactions. In the judgment of the Division, their reliance is not misplaced due to the degree of internal and external auditing to which the producer prepared information is subjected.

Under the circumstances prevailing earlier, such as limited staff, and severe time constraints, this appears reasonable. We recommend, however, the Division expand the application of detailed tests to include a larger percentage of tanker transportation costs. We believe this would be the most productive area to invest additional audit effort since it is generally the largest cost after the TAPS tariff, and is comprised of a very large number of transactions. It would be most likely, we believe, to result in additional assessments, of all the cost areas to which additional testing could be applied.

Recommendation No. 2

The Division of Petroleum Revenue should establish procedures to validate reported production volume data for the Prudhoe Bay field.

The Division of Petroleum Revenue does not maintain a close working relationship with the Alaska Oil and Gas Conservation Commission (AOGCC).

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While Petroleum Revenue has contacted AOGCC in the past in order to become familiar with their functions, contact was not maintained. Because of this, Petroleum Revenue has not been aware of Prudhoe Bay volume changes stemming from breakdowns in the metering system. If the producers do not prepare amended returns, Petroleum Revenue is unaware of necessary adjustments to oil and gas volume. During February and March 1980, a meter prover failure occurred at Pump Station No. 1 which was detected by Sohio. However, since Sohio did not submit amended returns, Petroleum Revenue was not aware of the adjusted production volumes until informed by us.

Since Petroleum Revenue needs the information to reconcile tax returns, a close working relationship should be developed with AOGCC to ensure an uninterrupted flow of production data.

Recommendation No. 3

The Division of Petroleum Revenue should sponsor legislation to increase the interest rate charged producers on delinquent production taxes.

The 1979 audit report recommended legislation to increase the interest rate on delinquent production taxes from six to eight percent per annum.

AS 43.55.060 provides specifically for interest to be paid on delinquent production taxes for gas and oil at the rate of six percent per annum. Conversely, however, if the producer should overpay his taxes he is reimbursed the amount of the overpayment plus eight percent interest per annum. By contrast, all other delinquent taxes carry an annual interest rate of eight percent in accordance with the provisions of AS 43.05.225. House Bill 187 was introduced during the 1979 legislative session to repeal AS 43.55.060. However, it failed to win approval.

In an era of high interest rates, six percent is inappropriate and should be increased to a more realistic amount. Further, the rate should be made consistent with the rate prescribed for reimbursement of overpayments.

Moreover, since the oil and gas production tax is one of the State's largest sources of revenue, and since short term interest rates greatly exceed six percent, interest charged should be great enough to deter producers from becoming delinquent with production tax payments.

Recommendation No. 4

The Division of Minerals and Energy Management should verify the reported Prudhoe Bay daily oil production.

This was Recommendation No. 13 in the 1979 audit.

The Division of Minerals and Energy Management receives copies of the daily log summaries, meter proof reports, and the Alaska Oil and Gas Conservation Commission meter proving field reports but they are merely placed in files.

Production data, based on run tickets, is currently accepted by both DMEM and the Division of Petroleum Revenue without verification. This poses the possibility of errors on production reports going undetected. The net effect could be discrepancies in the royalties received by the State.

DMEM should use the data provided by the Waugh instrument at Pump Station No. 1, and the daily run tickets, to double check the accuracy of reported production. This data should be provided to the Division of Petroleum Revenue for review and comparison so that any adjustments in production data which are required for severance tax purposes can be initiated.

Recommendation No. 5

The Executive Branch should inform the Legislature prior to entering into contracts of over one year duration for the sale of royalty oil or gas.

Phillips Petroleum Company, a producer of natural gas in the North Cook Inlet field, entered into an agreement with the Department of Natural Resources whereby Phillips agreed to take all the royalty natural gas which the State, under a separate contractual agreement, could not sell to the Alaska Pipeline Company. The terms of the initial contract with Phillips and a subsequent letter of agreement extending the contract had the effect of restricting the State's ability to recover additional royalties through audit adjustments to the price paid by Phillips for the natural gas.

We questioned the terms of the contract and Letter of Agreement based on the fact that the Executive Branch did not request Legislative approval as required by the provisions of AS 38.06.055.

The Attorney General in an opinion dated November 3, 1981, stated that AS 38.06.055 was unconstitutional based upon the separation of powers.

Inasmuch as AS 38.06.055 represents a clear expression of legislative intent, it would behoove the Executive Branch to foster a spirit of cooperation on this matter by affording the Legislature the opportunity to review contractual arrangements entered into for the sale of oil and gas which exceed one year in duration.

Recommendation No. 6

The Department of Natural Resources should revise and strengthen its contract procedures.

We found that contracts for the sale of royalty in-kind oil are poorly written and could lead to a loss of royalty revenue to the State.

All the contracts entered into with purchasers of Prudhoe Bay in-kind royalty oil include ambiguous clauses relating to adjustments to billings which could restrict the State's ability to revise billings to a period of twelve months or two years following initial billing, depending on whose interpretation is accepted.

Since the selling price for in-kind royalty oil from the Prudhoe Bay field is a monthly weighted average of all Prudhoe Bay producer's values, and since the values are subject to subsequent change through producer price revisions, correction of errors, and Petroleum Revenue audits, the inclusion in the contracts of time limitations on adjustments is unduly restrictive and we believe may constitute a violation of State law under the provisions of AS 09.10.120.

Recommendation No. 7

DMEM should initiate action to recover royalties for gas liquids passing through Pump Station No. 1.

On June 27, 1980, the Prudhoe Bay Field Unit Operator (Sohio) was notified by DMEM that the proper method of reporting gas liquids being metered through Pump Station No. 1 is the same as for crude oil. Royalty accounting cited AS 38.05.180(a) as the statutory authority. AS 38.05.180(a) states in part, "of such royalty as may be fixed in the lease".

Paragraph 2 of the standard competitive oil and gas lease, applicable to Prudhoe Bay, states that, "oil means crude petroleum oil and other hydrocarbons regardless of gravity which are produced and saved in liquid form at the well by ordinary production methods".

On April 3, 1981, Sohio was informed by Petroleum Revenue that gas liquids passing through Pump Station No. 1 should be treated as oil for tax purposes.

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Since gas liquids are to be treated as oil for tax purposes they should be treated as oil for royalty purposes.

Beginning June 1980, and continuing through April 1981, gas liquids equivalent to 49,152 royalty barrels have been metered at Pump Station No. 1. Total royalty in-value barrels amount to 22,219 with a total dollar value of $438,709. Of the 16 producers in the Prudhoe Bay field, only Exxon and ARCO have included gas liquids in their monthly payments for in-value oil.

The other 14 producers collectively owe the State $258,257 for the period June 1980, through April 1981. The State in turn owes ARCO $122,520 for overpayment for gas liquids.

DMEM should take the necessary action to recover the gas liquid royalties from the respective producers.

Recommendation No. 8

DMEM should exclude topping plant crude in its computations of in-kind royalty oil.

Billings to purchasers of royalty oil were overstated in the amount of $1,678,518 for the period November 1979, through April 1981.

Prior to July 1, 1981, lty barrels taken in-kind by the State were computed eac nth on the basis of total production, including gas liquids, times the percentage of total production each purchaser had contracted to purchase.

The amount of in-kind oil was then deducted from total royalty oil to arrive at in-value oil.

Included in the total monthly production is topping plant crude. Topping plant crude is oil which is diverted to a topping plant controlled by ARCO and Exxon where products are made for sale to contractors in the Prudhoe Bay field. Since oil diverted to the topping plant does not reach Pump Station No. 1, it should not be included in production wh n computing in-kind royalty oil.

DMEM is in the process of notifying the purchasers and will adjust future billings to reflect the overpayment.

In overstating in-kind royalty oil, DMEM understated in-value royalty oil by 12.5 percent of the amount taken by the topping plant. This will require additional payments by the Prudhoe Bay producers for in-value royalty oil for the period November 1979 to April 1981. To date, DMEM has not made these adjustments.

Recommendation No. 9

Adjustments should be made to in-value royalty payments in a timely manner.

In-value prices form the basis for the computation of the Exhibit "B" prices which are used in the monthly billings to purchasers of in-kind royalty oil.

If adjustments are made to the in-value prices of the producers, this will require adjustments to the Exhibit "B" prices charged the purchasers of in-kind royalty oil.

The adjustments are the result of producer revisions in the prices originally used for in-value royalty payments, extension errors discovered by DMEM, or Petroleum Revenue audits of producers.

We found that adjustments to the Exhibit "B" prices had not been made since August 1980. In addition, the adjusted Exhibit"B" prices used for May, June and August 1980, require further revision. These revisions are necessitated by errors in the quantity of barrels used, failure to include field costs in the in-value price, and producer revision of the in-value price originally used in the Exhibit "B" computation. The net effect as of April 30, 1981, of not making the adjustments was an understatement on billings of $595,269.

Additional adjustment may result from Petroleum Revenue audits of the producers which can affect the in-value prices. Changes in the in-value prices can affect the Exhibit "B" prices. As of August 3, 1981, the audits of the major producers in the Prudhoe Bay field had not been completed, although the audits of all major Prudhoe Bay producers are tentatively scheduled for completion by December 31, 1981.

Due to the time limitation imposed by the terms of the State's contracts with purchasers of royalty in-kind oil on billing adjustments, any delay in revising the Exhibit "B" price could significantly affect royalty revenues. At the present time there is some confusion over whether adjustments to billings are restricted to twelve months, twenty-four months or six years from the date of the billing. DMEM has attempted to obtain waivers from purchasers acknowledging the State's right to adjust billings up to six years from the initial billing date.

Most producers have acknowledged the State's right to adjust billings up to six years from the date of the initial billing However, Alpetco has stated that it will not grant the State the right to make adjustments up to six years but will enforce their interpretation of the contract which limits adjustments to twelve months.

Because of Alpetco's position the State should:

1. Determine the legality of the contract clauses which place restrictions on the timing of adjustments to billings.

2. Pursue aggressively the audits of the Prudhoe Bay producers to ensure completion at an early date in order to preclude the loss of revenue in case the Alpetco position should prevail.

Recommendation No. 10

Standard lease agreements should be revised to require producers to pay interest on all delinquent royalty payments for in-value oil.

For royalty in-value, standard competitive oil and gas leases include the clause "All royalty that may become payable in money to lessor shall be paid on or before the last day of the calendar month following the month in which the oil or gas is produced." During the period July 1977 through April 1981, there were 249 instances where royalty payments were recorded by the State subsequent to the payment due date. DMEM has not taken action to ensure payment by the producers within the time allowed.

Part of the cause of this apparent high delinquency rate is that some producers are not issuing warrants or initiating wire transfers until the last day of each month, in which case they are not being recorded by the State until the subsequent month. However, of the 249 instances noted, 124 showed late payments of between four and thirty-five days.

At the present time contracts with purchasers of in-kind oil include an interest rate on late payments at an annual rate equal to the prime rate plus 1.25 percent. Standard leases should be revised to include the same penalty for late payments by producers.

Recommendation No 11

DMEM should initiate procedures to validate payments made by Tesoro for in-kind oil for the period January 1, 1978, to date.

Our audit disclosed that payments made by Tesoro for the period January 1, 1978, to date have not been verified by DMEM. It appears that Tesoro overpaid the State $301,737 during this period. Unlike the procedures followed for purchasers of Prudhoe Bay oil, DMEM does not bill Tesoro. Tesoro prepares a statement of the in-kind oil delivered to it by the producers in Cook Inlet fields, and using posted field prices, computes the amount which it owes the State.

The data submitted by Tesoro is subject to review by DMEM. However, DMEM has not been reviewing the payments made by Tesoro. Part of DMEM's reasoning for not reviewing and adjusting the Tesoro payments is based on the findings of a United States Department of Energy audit conducted for the period November 1973, through December 1977. The audit found that Tesoro had overpaid the State $895,478. Since this audit is still subject to review, and since its findings have not been implemented, DMEM, on the advice of the Attorney General, has refrained from reviewing and adjusting Tesoro billings for accuracy subsequent to calendar year 1977.

Recommendation No. 12

DMEM should adopt procedures to account for and verify the accuracy of royalty revenues received on a shared basis with the Federal government.

This was Recommendation No. 9 in our 1979 audit.

The United States Mineral Leasing Act of 1920 provided that the State is to receive 90 percent of all bonus payments, royalties, and rentals, net of amounts payable to the Alaska Native Fund, derived from mineral leases on Federal lands within Alaska.

A United States Comptroller General's opinion, dated July 29, 1975, provided that payments derived from leases on National Wildlife Refuge System lands should not be shared with the State, but should be paid to the Federal Fish and Wildlife Service. As a result of the Comptroller General's opinion the State's revenues, from Federal royalties according to our 1979 audit report, decreased form $7,000,000 per year in 1975 to approximately $1,500,000 per year during the succeeding years.

In November 1975, the Alaska State Attorney General filed a suit contesting the action by the Comptroller General. The funds in dispute have accumulated in escrow pending resolution of the lawsuit which was decided in favor of the State by the United States Supreme Court during 1981.

Our 1979 audit recommended that DMEM ascertain the amounts currently held in escrow pending the outcome of the lawsuit. It was also recommended that DMEM maintain a continuous accounting of funds until the lawsuit was resolved in order to verify amounts due the State in the event of a favorable court ruling.

DMEM did not take the necessary steps to implement this recommendation. DMEM does not know whether the amount held in escrow is the correct amount due the State from the Federal government.

The Director of the Petroleum Revenue audit section has indicated to us that an audit of the United States Geological Survey, the agency responsible for accounting for joint Federal/State leases, will be completed during September 1981. The audit should determine the accuracy of the Federal payments to the State.

However, DMEM should establish procedures to validate future amounts remitted as shared royalties by the Federal government. They might, for example, arrange to receive copies of the monthly production reports submitted by producers to the Federal government as an aid in desk auditing.

Recommendation No. 13

DMEM and the Division of Petroleum Revenue should establish more effective communications.

Since receipts derived from taxes and royalties on oil and gas production constitute the bulk of the State's revenues, every effort should be made, by those responsible for billing, receiving, and accounting for the revenues, to ensure their accuracy.

During our review we noted that the close cooperation between the Division of Petroleum Revenue and the Division of Minerals and Energy Management envisioned by the Legislature when enacting legislation which transferred the audit function to Petroleum Revenue from DMEM (Reference Section 1, Chapter 61, SLA 1980) had not yet materialized. Petroleum Revenue, it was noted, had scheduled royalty audits, without the benefit of input from DMEM, the agency responsible for accounting for royalty revenues.

It should be noted that since the completion of our field work, initial steps have been taken by the respective agencies to improve their working relationship.

Recommendation No. 14

The Alaska Oil and Gas Conservation Commission should strengthen their review of meter proving data reports.

Five of twelve inspection reports reviewed for 1980 contained information that did not correlate to the corresponding meter ticket in the case of meter pulls, or to a pipeline company's proving report in the case of meter proving.

Since the twelve reports cover thirty-six meters and the five errors cover seven meters, the composite error rate was determined to be 19.5 percent.

A high error rate detracts from the integrity of the meter ticket which forms the basis for production data. This could in turn hamper the desk audit function through the presentation of conflicting data.

In addition to the seven instances cited above, the reports were fund to lack required field data (13 instances) or other data such as gross and/or net barrels (9 instances).

Adequate review procedures consistently applied could significantly reduce the error rate.

Recommendation No. 11 in the 1979 audit report addressed this issue.

STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

JAY S. HAMMOND, GOVERNOR

POUCH S
JUNEAU, ALASKA 99811
PHONE: (907) 465-2300

January 14, 1982

RECEIVED
JAN 14 1982
LEGISLATIVE
AUDIT

Mr. Gerald L. Wilkerson, CPA
Legislative Auditor
Division of Legislative Audit
Pouch W
Juneau, Alaska 99811

Dear Mr. Wilkerson:

RE: Review of Petroleum Revenues
Division of Petroleum Revenue
August 15, 1981

I wish to thank you for the opportunity to respond to your August 15, 1981 report regarding the audit of the Petroleum Revenue Division. We share an interest in ascertaining that all reasonable procedures are being taken to gain full compliance with Alaska's oil and gas tax statutes and the leasing contracts entered into with members of the oil and gas industry.

Recommendation No. 1:

Oil and gas production tax auditing should be expanded to include more detailed verification.

This ecommendation pertains to that portion of the tanker costs which represent approximately 4-8% of the entire cost of transporting crude oil from the point of production to the refinery gate.

Although there is a question whether these are "material," we do assure ourselves as to their accuracy. Our reliance on schedules provided by the tanker companies is based on several factors, including the fact that tanker subsidiaries are usually profit centers in their own right and it is, therefore, in their interests to keep expenses to a minimum. Our information is obtained from the tanker company records, not from the producing companies. We rely on the fact that internal control reviews are done by internal and independent auditors for these companies which verify the ability of the accounting systems to generate valid data from which these schedules are prepared. Nevertheless, when we encounter unusual results which create doubt about some of the expense amounts (particularly fuel and labor) we do select a sample and perform tests of transactions.

To resolve any differences of professional opinion about the degree to which these transactions should be tested, the Division has completed a statistical sample of these tanker operating expenses reported by the three major Prudhoe Bay producers. These tests have corroborated the results previously relied upon by the Division and will be available for

AGO 786181

review by Legislative Audit as soon as the work papers are assembled in final form.

Recommendation No. 2:

The Division of Petroleum Revenue should establish procedures to validate reported production volume data for the Prudhoe Bay Field.

We agree this additional step may be useful. It is possible that none of the 16 Prudhoe Bay producers, either as a matter of error or each of the producers acting in consort with each other, would file amended income or severance tax returns with the Department of Revenue. It is also possible that, as a result of either or both of these conditions, amended royalty reports might not be filed with DMEM. Therefore, a comparison by the Petroleum Revenue Division of the volumes reported to each of the Divisions would not necessarily disclose a meter error.

Recommendation No. 3:

The Division of Petroleum Revenue should sponsor legislation to increase the interest rate charged producers on delinquent production taxes.

We concur with this recommendation and the Division will continue its effort during the 1982 session to correct the disparity between the rate of interest paid on production tax refunds and that received from production tax assessments.

Recommendation No. 13:

DMEM and the Division of Petroleum Revenue should establish more effective communications.

The Petroleum Revenue Division is very much concerned with effective communication with DMEM as it equally is with other State and Federal agencies who have information which may improve the quantity or quality of the examinations performed by this Division.

Clear and cogent evidence of this Division's efforts, on its own motion, to obtain input from DMEM pertinent to the examination of royalty obligations, is found in documents prepared in September and October 1980. These documents identify each Alaska oil and gas producer, their respective type(s) of production, reported value, the materiality of their production and, if any, other important facts peculiar to that producer; however, the most important feature of the meetings giving rise to these documents was the mutual effort by both Divisions to pinpoint audit targets known at that time.

In addition, since those early discussions, the auditors in this Division have spent a considerable amount of time, before and during the audit of producers, gathering information from royalty reports maintained in the offices of DMEM. This of course affords ample opportunity for the personnel from each Division to continue their discussions of audit issues or develop new ones, as the case may be, and at the same time this procedure keeps DMEM aware of the examinations this Division has in progress.

Therefore, in light of the actions and operating conditions outlined above, it is obvious that this Division is concerned with effective communication and will continue its efforts toward that end.

Thank you again for an opportunity to comment on your report dated August 15, 1981.

Sincerely,

Thomas K. Williams

Thomas K. Williams
Commissioner of Revenue

TKW/LEN:hws

cc: Fred Boetsch, Director
Division of Petroleum Revenue

ALASKA OIL AND GAS CONSERVATION COMMISSION

Hoyle H. Hamilton HHH
Chairman

Thru: Lonnie C. Smith LCS
Commissioner

Blair E. Wondzell Blair
Petroleum Inspector

April 16, 1981

Changes Made to Correct Short-Commings Exposed by the Recent Legislative Audit.

During the recent legislative audit of our efforts to ensure oil shipments are accurately metered from those fields where the state has a royalty interest, I spent considerable time with the auditor, Stacy Wermuth.

During the audit, it became obvious that while the number of field inspections was adequate, our handling of the data was sloppy. We were noticeably deficient in the following 3 areas:

1. field reports were inadequately filled out;
2. field reports were not being checked in the office;
3. some of the field reports were being separated during the filing process.

As a result of the above, I analyzed the inspection trips which had been audited. I made a tabulation, by inspector, [illegible] correct and incorrect instances of data compilation for [illegible] meter proving and delivery ticket witnessing. As a result of my analysis, we have made changes to alleviate the problems discussed above. Actions taken are as follows:

1. The <u>Pump Station #1, Meter Proving Data Report</u> has been modified to better indicate the data which should be entered on the form. Lonnie and I discussed with the inspectors the importance of accurately and completely filling out the meter proving forms.
2. We set up a procedure whereby I would review all <u>Meter Proving Data Reports</u> before the inspectors transmit them to Lonnie.
3. I discussed with Fran why the report pages should not be separated during filing of the data.

While the auditor's report may indicate additional changes are necessary, the changes discussed in this memo were so obviously necessary that we have already initiated them. If additional changes are recom[illegible]nded in the auditor's report, we will analyze the recommendations [illegible] make the canges if they are warranted. If we believe the a[illegible]tional recommended changes are not warranted, we will provide you with detailed comments to substantiate our reasoning.

If you have any comments on my analysis of the meter proving reports, the actions taken to improve our data handling, or regarding this memo, I will be glad to discuss them with you.

STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

11TH FLOOR, STATE OFFICE BLDG.
POUCH M — JUNEAU 99811

January 13, 1982

RECEIVED
JAN 19 1982
LEGISLATIVE
AUDIT

Gerald L. Wilkerson, CPA
Legislative Auditor
Division of Legislative Audit
Pouch W
Juneau, AK 99811

Dear Mr. Wilkerson:

Re: Preliminary Audit
A Review of Petroleum Revenues
Division of Minerals and Energy Management

This letter addresses the findings and recommendations in your Preliminary Audit Report of December 21, 1981.

Opening narrative:

In the opening narrative describing the duties of the Division of Minerals and Energy Ma gement, there is a slightly misleading statement in the last sentence of the first paragraph on page 3 regarding the agreement between Phillips troleum Company and Alaska Pipeline Company. Article 4.3 of Phillips' ntract states that "lessee agrees to purchase from the state from time-to-time those volumes which APC is unable (emphasis added) to take." We suggest that the last sentence of your report be modified to read, "There is also an agreement with Phillips Petroleum Company, the producer, under which Phillips agrees to purchase any gas Alaska Pipeline Company is unable to take, at a price established by Phillips."

Recommendation No. 4:

The Division of Minerals and Energy Management should verify the reported Prudhoe Bay daily oil production.

As you are probably aware, until last fall the Royalty Accounting section of Division of Minerals and Energy Management (DMEM) was severely short of staff. This lack of staff prevented implementation of your 1979 recommendation.The 1981 Alaska Legislature approved Governor Hammond's Fiscal 1982 budget request for Royalty Accounting personnel and an online mini-computer. The mini-computer is expected to be operatonal by March 1, 1982. Royalty Accounting software programs have been written and are now operational.

AGO 786186

We agree that the daily log summaries and meter proof reports should be verified against the daily run tickets from Pump Station 1. On November 1, 1981, DMEM began manual verification of these documents to check the accuracy of reported production. A program will be written this spring to transfer this function to the computer.

Recommendation No. 5:

The Executive Branch should inform the Legislature prior to entering into contract of over one year duration for the sale of royalty oil or gas.

Although the Attorney General has determined that AS 38.06.055 is unconstitutional based on separation of powers, it is the department's policy to send royalty oil and gas contracts to the Legislature for review and approval if they exceed one year in duration. The royalty oil contracts currently being negotiated will not be effective until approved by the Legislature.

Recommendation No. 6:

The Department of Natural Resources should revise and strenghten its contract procedures.

I concur with your assessment that some provisions of the in-kind royalty contracts may be poorly drafted and do not adequately protect the state's interest. I recognized this problem very early in my tenure as commissioner, and already have taken actions to assure that the standard royalty oil contract fully protects the state's interest. The standard contract first underwent intensive in-house scrutiny, and was then reviewed by the best outside lawyers we could obtain.

In the royalty oil sale negotiations currently under way, we are insisting upon a provision which would allow adjustments to billings based on any bona fide audit by the State if the audit is commenced within six years of billing. However, as with prior contractual provisions, our purchasers are extremely opposed to such a long adjustment period. The final provisions in the new contract will result from negotiations on all terms of the contracts.

The Attorney General has addressed your questions concerning AS 09.10.120 and concluded that the time limits on adjustments, although restrictive, do not violate this provision of state law.

Recommendation No. 7:

DMEM should initiate action to recover royalties for gas liquids passing through Pump Station No. 1.

As you correctly note, DMEM notified the Prudhoe Bay Field Unit Oil Coordinator (Sohio) in June, 1980, that gas liquids are to be treated as oil for royalty reporting purposes. In April, 1981, Petroleum Revenue notified Sohio that gas liquids are to be treated as oil for tax purposes. On

August 31, 1981, the Unit Oil Coordinator notified all working interest owners by letter of the gas liquids volumes from June 1980 to the present which are necessary to report gas liquids for royalty and tax purposes. It should be noted that the Unit Oil Coordinator is merely notifying the working interest owners of the correct gas liquids volumes; each working interest owner is responsible individually for reporting royalties owed the state.

Twelve of the sixteen producers have made the necessary corrections to their royalty reports and paid the royalties due. As of this date, ARCO, Alaska, Inc., which has always reported its gas liquids as gas, Phillips, Louisiana Lands and Exploration Company, and Marathon have not made the needed corrections. DMEM is in contact with these companies, and the Division expects all issues resolved by April 1, 1982. We believe the net amount owed to the State from these four companies due to this issue is approximately $14,000. In the event our discussions with these four producers are unsuccessful, we will take enforcement action to obtain the required corrections and collect the royalties owed.

Recommendation No. 8:

DMEM should exclude topping plant crude in its computations of in-kind royalty oil.

We were aware of this problem prior to the audit, and already had taken steps to implement your recommendation. DMEM is still in the process of adjusting the amounts owed by the producers for in-value royalty oil for the period November 1979 to April 1981. These adjustments will be complete by April 1, 1982. Credits to adjust the overbilling for royalty in-kind sales have been given.

Recommendation No. 9:

Adjustments should be made to in-value royalty payments in a timely manner.

At your request, I asked the Attorney General to examine the legality of the contract clauses which place restrictions on the timing of adjustments to billings. The Attorney General has concluded that these clauses are legal.

DMEM has in the past and will continue in the future to urge that Petroleum Revenue complete audits of the Prudhoe Bay producers as soon as possible.

We have examined the effects of not making adjustments to billings as of April 30, 1981, which you say resulted in an understatement on billings of $595,269. Our analysis shows that the net effect as of April 30, 1981, was an overcharge of $1,486,368.45. DMEM will have all in-value corrections up to date for the final billings for royalty oil purchasers which are taking their last deliveries January 31, 1982.

Generally, we agree that adjustments should be made to in-value royalty payments, as well as in-kind billings, in a more timely manner. Increased staff and computer capability have already enabled the Division to make great improvements in this area.

Recommendation No. 10:

Standard lease agreements should be revised to require producers to pay interest on all delinquent royalty payments for in-value oil.

I agree with the concept of this recommendation, and had recently come to a similar conclusion in a related matter. We are examining several alternatives in an attempt to find the best legally defensible way to accomplish this. The standard state oil and gas lease form will be revised before Competitive Oil and Gas Lease Sale 36 (Second Beaufort Sea, scheduled for May 26, 1982). The revision will include a provision requiring payment of interest on delinquent in-value payments. We will also revise the lease form to make clear that an in-value payment is delinquent unless it is received (rather than "paid") on or before the last day of the calendar month following the month in which the oil or gas is produced.

We believe that the amount of money owed to the State due to the 249 delinquent instances noted is very small.

Recommendation No. 11:

DMEM should initiate procedures to validate payments made by Tesoro for in-kind oil for the period January 1, 1978 to date.

The State Department of Law is undertaking active settlement negotiations with the federal Department of Energy to resolve the Tesoro pricing dispute. The Department of Law has advised us to continue to refrain from adjusting Tesoro billings for the period January 1, 1978 to February 1, 1981, while settlement negotiations are underway. In the event these negotiations do not result in an acceptable settlement, the Department will then pursue a resolution of this dispute.

Recommendation No. 12:

DMEM should adopt procedures to account for and verify the accuracy of royalty revenues received on a share basis with the federal government.

We concur with this recommendation and have communicated with Secretary Watt on this issue. In the fall of 1981, DMEM instituted procedures to monitor the income collected by the USGS that is owed to the State. By March 1, DMEM will have completed written procedures on this subject. Until very recently, DMEM's lack of royalty accounting staff precluded implementation of Legislative Audit's prior recommendation.

The Division of Petroleum Revenue has completed its audit of payments which accumulated in the suspense account pending resolution of the dispute regarding disposition of royalties from National Wildlife Refuge System lands, as well as all shared federal-state mineral income. The Petroleum Revenue audit concludes that the state has received its correct share of the mineral income received by the federal government.

AGO 786189

Recommendation No. 13:

DMEM and the Division of Petroleum should establish more effective communications.

The Department agrees with your assessment and recognizes the necessity for improved communications between DMEM and the Division of Petroleum Revenue. We also recognize that achieving this goal will require the cooperation of both agencies. Due to differing interpretations of the stautory roles and obligations of the respective departments, the interaction has not proceeded as smoothly as we desired. One action we have recently taken that should aid in improving communications between the divisions is the hiring of Ms. Donna Wood as Royalty Manager (Accounting Supervisor V) to head the DMEM Royalty Accounting section. Ms. Wood was formerly a field auditor with the Division of Petroleum Revenue.

I would be happy to meet with you to discuss these issues. Please let me know if further information is required.

Sincerely,

John Katz
Commissioner

STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

ALASKA OIL AND GAS CONSERVATION COMMISSION

3001 PORCUPINE DRIVE
ANCHORAGE, ALASKA 99501-3192
TELEPHONE (907) 279-1433

January 5, 1982

RECEIVED
JAN 11 1982
LEGISLATIVE AUDIT

Gerald L. Wilkerson, CPA
Legislative Auditor
Division of Legislative Audit
Pouch W
Juneau, Alaska 99811

Dear Mr. Wilkerson:

We have received the Preliminary Audit Report:

> A Review of Petroleum Revenues, Department of Revenue, Department of Natural Resources, Alaska Oil and Gas Conservation Commission, August 15, 1981.

The only recommendation which applies to the Commission is Recommendation No. 14 which reads as follows: The Alaska Oil and Gas Conservation Commission should strengthen their review of meter proving data reports. We recognized the need for this action while your auditor, Stacy Wermuth, was conducting his audit; therefore, revised procedures were developed and implemented per our internal memo of April 16, 1981, copy attached.

Since our implementation of the changes were pointed out, and a copy of the attached memo was given to Mr. Paul Harrison when he conducted his exit interview on August 21, 1981, we are surprised this was not mentioned in your Preliminary Audit Report. We hope that you will include this information in your final report.

If we can provide additional information, please contact me at 279-1433, or at the above address.

Sincerely,

Lonnie C. Smith

Lonnie C. Smith
Commissioner

Attachment

AGO 786191

SB
881

COMMITTEE REPORT

SENATE

3/29/82

FURTHER: Finance
Judiciary

Date: 4/7/82

Mr. President:

The Committee on RESOURCES has had SB 881

sale of royalty oil by the State of Alaska to the Tesoro Alaska Petroleum Company

under consideration and (a majority of the committee) (the committee) reports it back with the following recommendations:

[✓] do pass [ ] do not pass

[ ] do pass with attached amendments(s)

[ ] replace with CS for ______ [ ] same title [ ] new title

and recommends ______

[ ] AND attaches a "Letter of Intent" [ ] New Fiscal Note

[ ] reports it back without recommendation

[ ] referred to the ______ Committee

MEMBERS SIGNING DO PASS

Don Gilman

[illegible]

[illegible]

[illegible]

[illegible]

MEMBERS HAVING OTHER RECOMMENDATIONS:

[illegible]

CHAIRMAN

S 60 (Rev. 12/78)

AGO 786297

Alaska State Legislature

SENATE
Resources Committee

Official Business

BETTYE FAHRENKAMP, Chairman
VIC FISCHER, Vice-Chairman
BRAD BRADLEY
DICK ELIASON
DON GILMAN
BOB MULCAHY
ARLISS STURGULEWSKI

POUCH V
STATE CAPITOL
JUNEAU, ALASKA 99811
(907) 465-3834
(907) 465-3835

March 25, 1982
5:00 p.m.

House Finance Committee Room
Room 519 - Capitol Building

Meeting with House Joint Committee on Oil and Gas

MEMBERS PRESENT

Senator Fahrenkamp	Representative Halford
Senator Gilman	Representative Cotten
Senator Fischer	Representative Randolph
Senator Mulcahy	Representative Rogers
Senator Sturgulewski	Representative Fanning

Hearing: Presentation by the Department of Natural Resources, the Alaska Royalty Oil and Gas Development Advisory Board, Doyon, Ltd,. and Tesoro Alaska Petroleum Co., on the proposed Alaska royalty oil contracts.

The meeting was called to order by Rep. Halford, Chairman.

Dick Lyon, Chairman, Alaska Royalty Oil and Gas Development Advisory Board, presented two resolutions passed by the Board, recommending that the Legislature approve the Tesoro contract, and disapprove the Doyon contract. Mr. Lyon stated that the function of the Board was to make the extensive contract negotiations as public as possible while still holding private negotiations. The conclusions of both resolutions were read into the record.

John Katz, Commissioner, Department of Natural Resources, presented the Tesoro contract for approval, with the full support of the administration. The Commissioner stated that the Department agrees with Board's recommendation on the Doyon contract, while disagreeing with one of their premises for the recommendation.

Mr. Katz outlined the procedural criteria used by the Department in its contract negotiations: that the decisions must be fair and be perceived to be fair by all participants and the public; that there should be an effort to institutionalize the royalty oil and gas decision-making process; that there should be a clear paper trail documenting the decision-making process; that the process should

AGO 786232

increase the knowledge of atate royalty oil and gas decision makers; that the standard form for royalty oil and gas contracts should be improved; that the Department should improve its working relationship with the Board.

The culmination of the effort was a very tough, workable contract form and the findings document.

Commisioner Katz testified that when he came on-board, the Department revised the pending solicitation to reflect the in-state preference in the statutes. They received 29 responses. In a winnowing process, they met with all respondents who wanted to, made a series of findings, and allowed rejected respondents a chance to refute the Department's conclusions. They continued negotiations with 8 or 9 serious proposals.

Mr. Katz reviewed the policies applied in the negotiations:

1) a clear--but not absolute--preference for in-state taking of royalty oil and gas;
2) parity between all parties in terms of major contract conditions;
3) adopting a wieghted average field pricing system for the North Slope, with contractual adjustments pending the result of the Amerada Hess litigation, with 3% above the higher of the state treasury rate or the prime rate to be paid;
4) a twelve year term;
5) retain a significant uncommitted volume for future options;
6) establish an option fee to be paid on contractually committed oil not taken by the processor;
7) no interim taking--no state oil to finance a project that wouldn't be otherwise financable;
8) the state is willing to be the 100% supplier of royalty oil to in-state processors, to provide a secure base for operations and future expansion;
9) return oil--oil that is left at the end of the refining process--requires the payment of a quality penalty if put back in the trans Alaska pipeline for downstream use;
10) attempted to gain concessions for rural Alaska;
11) attempt to use royalty oil to complement coal development through the development of petrocoke.
12) there is a definite negative impact on in-value price and severance taxes from Alaskan oil due to displacement of west coast oil, that could amount to $10 million per year, as a rough estimate, but that this possible loss to the state is outweighed by other benefits;
13) royalty oil should not be used as leverage to enter into other than the petroleum market;
14) all contracts should have adequate security.

Commissioner Katz made the following observations:

1) that the Department was negotiating the contracts at a time when their leverage for negotiation couldn't have been worse; there is an oversupply of oil, and potential purchasers have alternative sources of supply; however, the state had a satisfactory alternative in that the state could let the producers take the oil in-value and sell it for the state; the producers are the best long-term marketers of Alaskan crude oil;
2) in some situations it would be to the state's advantage to offer royalty oil for purchase by competitive auction, but two factors work against it; first, auctioned oil would displace west coast oil, with a negative effect on in-value and well-head price; second, while the state did well in some competitive solicitations last summer, oil producers are still the best long-term marketers of oil.

Commissioner Katz summarized the current status of the contract negotiations. There are five contracts still pending. The Tesoro contract is recommended for approval. The Doyon contract will be recommended for approval if they can have the financing in place in a few weeks. There are three other good posibilities being negotiated, with Chevron, Provident Oil, and Suneel. There are a number of questions to be answered on the Provident and Suneel contract proposals. The state intends to commit itself to a written process to address these questions, preparatory to further contractual negotiations.

Bob Maynard, Assistant Alaska Attorney General, addressed the issue of pricing systems. The "exhibit B" purchasing system attached to the Alpetco contract presents a regrettable position with respect to the Amerada Hess litigation, requiring the purchaser to pay the higher of either the price reported to the state by the producer, or the average of all other producer prices, resulting in a term higher than the weighted average price but lower than the highest price.

The basic difference between the exhibit B pricing and the system used in the proposed Tesoro contract is that by the exhibit B system, Alpetco paid the state as if the state had won the lawsuit, and Alaska will have to pay them back if the case is lost; Tesoro will pay the state as if the state had lost the lawsuit, and pay the state the difference should the state win.

Commissioner Katz, in response to a question from Senator Fischer, addressed the issue of alternative pricing systems. There are negative impacts on state revenues by using the weighted average field price, but the contractual adjustments pending resolution of the Amerada Hess litigation, with the 3% above prime aspect will recapture the difference.

All pricing system alternatives were examined, and exhibit B pricing was rejected for two basic reasons: first, the recapture mechanism currently being used is good; second, exhibit B pricing impairs in-state oil utilization because of the uncertainty regarding the price for long periods after the actual tranaction. To serve in-kind taking, the Department felt the state should deviate from exhibit B pricing, recognizing that there will be adjustments in the aftermath of the Amerada Hess litigation.

Jeff Haynes, Deputy Commissioner of Natural Resources, stated that the market situation has changed considerably in the last twelve years, and would change considerably in the next twelve. The basic decision regarding the pricing was to tie it to the price that seven-eighth's of North Slope crude was sold for. The two-tier pricing system is in place for specific and economically justifiable reasons. It is possible that exhibit B pricing without the Amerada Hess adjustment could be a premium price in twelve years; the situation could change; it is hard to predict. Given the market influences, however, it is more likely to be less. The Department believes that its estimates are as accurate as possible.

Commissioner Katz, in response to a question form Senator Fahrenkamp, stated that there is no direct assurance that the lower price to processors will be reflected in consumer costs. That sort of guarantee would be difficult to negotiate. That is why the Department continues to negotiate with Doyon--it is good for the state to promote competition, to increase benefits to consumers.

In response to comments from Rep. Halford, Commissioner Katz pointed out that there is an inherent statutory conflict between maximum revenues for the state and the preference for in-state use. In the case of the Doyon contract, there is no question that another refinery would lead to significant price competition in the greater railbelt area. The trade-offs are difficult to quantify, but the Department will provide the legislature with such figures for cost-benefit analysis as are available.

In response to questions from Rep. Rogers, Commissioner Katz stated the legislature should enact a statute to approve the contracts. If Doyon can get financing satisfactorily in place in the next few weeks, the Department would recommend legislative approval. If, however, the legislature enacted legislation approving the Doyon contract without adequate financing in place, the Department would recommend that the Governor veto the bill.

In response to further questioning, Mr. Katz stated that if the Doyon contract is not approved this session, the Department would continue to pursue it over the interim. The Attorney General's office advises the Department that this solicitation can continue until terminated at the Commissioner's discretion. Commissioner Katz would like to bring this solicitation to a conclusion in the next few months, with an outside limit at the end of Governor Hammond's current term. After that conditions will change, and warrant a new solicitation.

The Department has been advised that Tesoro would have to enter a new solicitation for addittional oil for expanded facilities, such as a hydrocoker. This is also relevant in the light of the policy only to provide royalty oil for "imminent" projects; which is another reason the Department wants to terminate this solicitation in a timely manner. It was with this situation in mind that the Department retained a quantity of oil for future options.

Deputy Commissioner Haynes pointed out that paragragh 2.13 of the Tesoro contract contains a provision recognizing the statutory preference for in-state use of royalty oil and the manufacture of petroleum products; which means that Tesoro would automatically be involved in future solicitations.

Commissioner Katz stated that the current solicitation could be amended simply, to allow continued negotiations with Tesoro, and that the statutes, while favoring mass solicitations, do allow for individual negotiations, which could be used to allow for supply for further Tesoro expansion.

Bob Maynard pointed out that it is a problem of wo ding; Tesoro's expansion can't come under the current solicitation, but the solicitation can be amended to allow for it.

Commissioner Katz, in response to question from Rep. Rogers, pointed out that if the state wanted to renegotiate the contract with Doyon, they could go about it two ways: (1) withdraw the contract, make the desired changes, and send it back through the Board process; or (2) the Legislature could waive that procedure in the enacting legislation for the renegotiated contract.

Mr. Katz stated that the return oil situation was not as serious a problem for processors on the trans-Alaska pipeline, who can put residual oil back into the line. The state has a good policy of selling all title to royalty oil at Pump Station #1. The Department looked at cooperative agreements for Doyon to sell the return oil to a downstream processor, but the arrangements did not work out. Chevron dropping out of the negotiations had a material effect on the Doyon contract.

Mapco's return oil under existing contract is owned and sold by them. Depending on market conditions, this can either be a benefit or a drag to the processor.

Deputy Commissioner Haynes stated that it depended on the market; in the case of the Fairbanks refinery, they can dump residual oil back into the pipeline, and pay a quality penalty, but then sell it as Alaska North Slope (ANS) crude at Valdez, in competition with the producers. It has been both a good and bad deal for them in past years. With the failure of the Chevron to buy the return oil, Doyon will have to sell ANS crude.

John Katz, in response to a question from Rep. Cotten, pointed out that although he did not agree that it is constitutionally required, the Governor has set a clear policy that he wants a legislative decision for the approval or disapproval of royalty oil contracts.

Bob Maynard pointed out an additional advantage to statutory approval, that in doing so, the Legislature would be "ratifying" the contracts, Curing any procedural faults that may have occurred up to that point.

John Katz stated that the state is selling at the weighted average of what all North Slope producers charge. Sohio made an offer to buy most of the royalty oil at a greater than weighted average price for resale to in-state processors, but policy dictated that the state couldn't allow a private concern to make what should properly be public decisions regarding state royalty oil.

In response to a question from Senator Fahrenkamp, the Commissioner stated that the Suneel proposal is still active, but not the highest priority. The unanswered questions on this project will not be resolved in time for consideration by this Legislature. If the questions could be resolved in time, the Legilslature would have the option of allowing the contract to go through the usual royalty oil procedure, or waiving the process in enacting legislation this session.

Senator Halford noted that the Department recommends that the Legislature approve the Tesoro contract, and approve the Doyon contract, with a four-year moratorium on option fees, if a financing package goes through. Two separate pieces of enacting legislation should be introduced.

Jeff Haynes presented a summary of highlights of both contracts:

The Tesoro contract calls for the purchase of 46,000 barrels per day, which is about the maximum the Tesoro refinery can handle. Tesoro also currently contracts for about 8,500 barrels per day of royalty oil from the Cook Inlet. These reserves are declining. Tesoro can vary the amount to be taken, up to 46,000 barrels per day, on six month's notice. The state can impose a permanent top-limit equal to the greatest amount taken in the first five years of the contract. Tesoro can permanently terminate the contract on nine months notice. The price is the producer's weighted average field price, subject to adjustment as a result of the Amerada Hess litigation. Any money owed the state would be paid at the higher of the state treasury rate or the prime rate plu three percent. The contract term is twelve years, and the oil is to be processed in-state, with an equal-value exchange provision. The oil will have to be processed at the Nikiski refinery, and there are standards for how much of certain products they shall produce. Tesoro is committed to completion of feasibility studies for expansion, to include a petroleum coker. The state retains an option on the residual oil and petrocoke, and can assign its use. The performance and guarantee reservation structure is a fee paid to the state on contractually committed oil, if not actually taken--about fifteen cents per barrel per day. The security terms require a letter of credit worth two month's supply of oil. The Attorney General's Office thinks that the local hire provision in the contract goes as far as the state is constitutionally allowed.

Doyon had two contracts in the course of negotiations: one to purchase the Mapco refinery; one to build a new refinery. The contract to take over the Mapco refinery was withdrawn.

The volume of the Doyon contract is 50,000 barrels per day; the price and term are the same. The in-state processing provision is similar, except that it includes a definition of a required schedule; they are required to build, open and operate a new refinery by December 1, 1983, or the contract will terminate. The contract contains a provision for a future new refinery or new royalty oil contracts, and contigencies to cover the state's interests should Doyon acquire the Mapco refinery.

In response to Senator Sturgulewski, Mr. Haynes stated that unlike the Charter Oil contract, which had many complexities and procedures for legislative review of the fulfilment of the conditions of the contract, the Doyon proposal was not for a world-class facility, and was simpler to track.

Bob Maynard pointed out that the contracts have a conflict clause, similar to the procedure for administrative review of regulations, whereby contract disputes or ambiguities regarding a term of the contract shall be determined by the Commissioner first, and that the buyer must adhere to the Commissioner's decision, unless there is a preponderance of evidence to the contrary.

The Committee adjourned at 7:00 p.m.

Offical Business

Alaska State Legislature

SENATE
Resources Committee

POUCH V
STATE CAPITOL
JUNEAU, ALASKA 99811
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(907) 465-3835

BETTYE FAHRENKAMP, Chairman
VIC FISCHER, Vice-Chairman
BRAD BRADLEY
DICK ELIASON
DON GILMAN
BOB MULCAHY
ARLISS STURGULEWSKI

March 26, 1982
8:15 a.m.

House Finance Committee Room
Room 519 - Capitol Building

Meeting with House Joint Committee on Oil and Gas

Members Present

Senator Fahrenkamp
Senator Gilman
Senator Sturgulewski

Representative Halford
Representative Cotten
Representative Randolph
Representative Rogers

Hearing: Presentation by the Department of Natural Resources, the Alaska Royalty Oil and Gas Development Advisory Board, Doyon, Ltd., and Tesoro Alaska Petroleum Co., on the proposed Alaska royalty oil contracts (continuation from March 25, 1982).

The meeting was called to order by Rep. Halford, Chairman.

Avrum Gross, General Counsel for Doyon, Ltd., stated that the contract had been negotiated by Dick Edwards and Marco Pignalberi. Doyon has worked since its inception to put together a competing refinery in Fairbanks. They have acquired the equipment and completed the engineering and land-acquisition work, simultaneously negotiating with the state for the last five or six months.

Mr. Gross became involved in early January. At that point, Doyon had the opportunity to negotiate to purchase the North Pole refinery, and switched over to negotiating both contracts with the state. Negotiations for purchase collapsed after about six weeks. By this time, the status of the refinery construction financing had changed, The financers had pushed Doyon to pick-up the refinery. The return oil was the main problem in negotiations; for every 30,000 barrels to pass through the refinery, 20,000 barrels are returned to the pipeline, and would have to be sold by Doyon. Marketing that amout of oil without a substantial loss is difficult. They were originally intending to dispose of return oil to Chevron under contract, but that contract fell through. This has been the major snag in obtaining financing; Doyon will have a much better idea of their ability to dispose of return oil in two to three weeks.

Mr. Gross noted that this is not a contract like the Alpetco contract, where Doyon could market oil as it sees fit. The contract requires Doyon to build a refinery and get it on line by December 1, 1983. As a new project, it is difficult, amounting to a $100 million investment in a world oil situation not conducive to major investment.

Mr. Gross suggested that the Legislature put the Doyon contract on hold for two or three weeks, and Doyon will make another presentation to the Legislature at that time.

In response to a question from Rep. Halford, Mr. Gross stated that he was surprised at the Advisory Board's reaction to the four-year waiver on option fees. Mr. Tim Wallace, President of Doyon, testified before the Board in Fairbanks, and was asked no question regarding the waiver. The negotiations for the contract took 5 months, and Doyon made trade-offs to gain this concession. The only way to determine if the clause is indeed anti-competitive would be to do an analysis of Mapco's situation. To come "out of the blue" and pick on one term without considering the other factors and the conditions of the Mapco contract is not a correct procedure.

In response to Senator Fahrenkamp, Mr. Gross recommended that the Legislature put the contract into legislation, and hold in committee, awaiting financing. At some point, the Legislature will have to make a judgement on the good-faith and viability of the Doyon proposal. In the interim until the refinery is completed, the royalty oil would be marketed by the producers, at no loss to the state.

In response to Rep. Randolph, Mr. Gross stated that the financing for refinery construction had been in place with the Continental Bank in Chicago. As the emphasis shifted to negotiating for the Mapco refinery, the bank made a financial commitment to the purchase, and withdrew its commitment to construction. When it became clear that the purchase might not go through, the situation for construction had changed. Continental wanted to change the terms and seek involvment by others in the financing, primarily because of the risk involved with the return oil. Return oil has been the major drain on the North Pole refinery profits. When Mr. Gross last spoke to Continental, they were willing to finance a major portion of the project, insisting on the financial involvment of others. If Doyon can find a way to dispose of the return oil, he sees no problem in putting together a financing package.

In response to Rep. Rogers, Mr. Gross stated that provision had been made to store the purchased equipment until financing was available, and that on-site work had been shut down for the time being. If Doyon is able to continue work in this construction season, they could have the refinery in place before the December 1983 deadline.

In response to Rep. Cotten, Mr. Gross stated that not having the contract approved until the next legislative session would create a problem, in that the contract is a integral part of the financing package. However, the Doyon proposal is not a speculative proposition; they are committed to follow through on the project.

Mr. Gross stated that Tim Wallace was negotiating with several oil companies for a contract for the return oil. There is the problem caused by the current oil glut. Doyon is not concerned with making a profit on the return oil, but with avoiding a loss. The North Pole refinery has had enormous losses in the past, but has recently made arrangements to avoid more serious losses.

Jeff Haynes stated that the Department made the four-year option waiver concession to Doyon as a new entrant. The most difficult philosophical question in the negotiations was reconciling being totally market neutral and yet encouraging competition. The bottom line for the Doyon contract is the Mapco contract. Doyon would prefer to have the Mapco contract for competitive reasons, but the Mapco ocntract has provisions that are not recognized as being in the best interest of the state at this time. The Department was under intense pressure from Doyon throughout the negotiations to make concessions; but the only significant concession was the waiver on reservation fees.

Mr. Haynes stated that there was an advantage to a refinery on the transAlaska pipeline, in terms of return oil. They have to sell Alaska North Slope crude oil with a quality penalty, rather than residual oil, which is a bigger problem. The Department tried to work out a deal with Chevron to use the residual oil from the Mapco refinery, which would have been to Doyon's advantage on some occassions, but Mapco didn't want to give up their absolute rights to the return oil, so the contract fell through.

Deputy Commissioner Haynes stated that in terms of Doyon's financing, the Department was applying the criteria that they would contract for royalty oil only for projects that were operating now or were imminent. The Department concurs with the Advisory Board's recommendation to postpone the Doyon contract if financing is not in place in short order, but disagrees with the Board's stand on the reservation fee issue.

In response to Senator Fischer, Mr. Haynes stated that it might not be aprropriate for the Legislature to pass an approval bill for the Doyon contract, conditioned on a finding by the Commissioner or Governor that financing was in place, because the Department does not want to see a group with a supply contract but no deal put together, using the contract as leverage for financing. They prefer to have the issue settled in the course of the Legislature.

Avrum Gross pointed out that the contract has a built-in time limit. With the construction season in Fairbanks being what it is, if Doyon

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cannot begin construction next year, the new refinery might not happen. If the Legislature were to approve the contract, the time limit for completion is built-in.

Jeff Haynes, in response to questions, stated that there could be problems with conditional legislative approval of the contract. At some point after this session, stretching the solicitation procedure out would be unfair to other parties to the negotiations. The Department has used the standard that processing facilities must either be operating or imminent. A supply contract will not make a project viable if it were not viable otherwise. In terms of conditional approval, the state has to look at the other proposals. Others wanted more barrels for expansion, which could yeild more competition. The total amount requested added up to more than the state has available; the state rejected their proposals. It would be unfair to them to extend the time for Doyon too long.

Dick Lyons, Chairman, Alaska Royalty Oil and Gas Development Board, stated that in the Board's perspective, the imminency of a project was a concern. They did not want to commit state crude to any project which wasn't going forward. There was the issue of competition. Both proposed contracts--Tesoro and Doyon--involve about $1 million per day in royalty oil. The crude would be sold for dissimilar prices under similar conditions and terms. If it were a private supplier, and not the state, federal law would prohibit it.

In response to Rep. Halford, Mr. Lyons stated that if the Legislature were to introduce bills for both contracts, the Board could meet in short order to consider a financing package for the Doyon project, if one were to come forward.

Rep. Halford stated that the Legislature should move forward with both proposals this session, and hear from the Department of Natural Resources and the Advisory Board on the financing package for Doyon, if one is forthcoming.

Mr. Gross stated that the Legislature is probably just as qualified to judge on the merits of a financing package as the Board, and could speed the decision process by waiving Board review.

Dennis Jurin, President, Tesoro Alaska Petroleum Company, testified that Tesoro has the capacity to supply over 100 percent of the gasoline required in the state at present. The company started in 1969 with an 18,000 barrel per day capacity refinery in Kenai, and has expanded it to almost 50,000 barrels per day. They did it on the basis of a relatively small Cook Inlet royalty oil contract, and each expansion after inception had no other subsidy than an opportunity to buy royalty oil on a competitive basis.

Mr. Jurin stated that Tesoro was a respondent in the 1977, when the North Pole refinery requested a contract. The Tesoro proposal was not approved, and Tesoro did nto push the issue, which, in hind-sight, the company should have. Due to rapid growth through aggressive marketing, Tesoro has placed itself in a vulnerable position, with most of their supply of crude coming from foreign sources and spot market purchases. The Cook Inlet supply is dropping at a rate of about one percent per month. The majority of the supply is either foreign or domestic short-term contracts, subject to interruption. Tesoro wants a relatively secure long-term supply contract not subject to rapid changes.

Mr. Jurin stated that Tesoro is considering expansion of their facilities. They began research in November, 1981 on market growth in Alaska, the probable product-mix and preliminary engineering. It is possible that as much as 70,000 barrels per day could not be fully utilized until 1995, and Tesoro might settle on about 55,000 to 60,000 barrels per day. One primary consideration in their planning is what happens to the Adisory Board recommendations here. A gasoline producing refinery in Fairbanks would effectively close that market to Tesoro in the Interior, as is the diesel and turbine fuel market already, due to production by the North Pole refinery. It costs Tesoro eight to nine cents per barrel to transport gasoline to the Interior, and an on-site refinery their would have an unbeatable competitive edge. Therefore the decisions here have a lot to do with what Tesoro builds in the Kenai.

Mr. Jurin discussed the return oil situation. The west coast utilities are the largest users of residual oil; they will have abundant supplies from other sources. Tesoro intends to convert the residual oil to petrocoke or use a hydrogenation process to convert it to turbine or diesel fuel. They are currently running a pilot plant project on their feedstocks to test the processes. Union Oil Research is the licensor of Tesoro's first hydrocracker in Kenai; they are negotiating with them for a possible second facility, and have engaged engineers for design investigation.

Mr. Jurin stated that Tesoro's corporate finance group is meeting with financial institutions to determine the best way to finance the expansion. All the decisions will probably be made this year. The proposed contract requires Tesoro to periodically report to the Commissioner on the progress of evaluation, planning and development of the project. The contract would remove a degree of vulnerability in supply, and help maintain Tesoro as a formidable competitor in Alaska. The ifference between the Tesoro proposal and others is that Tesoro is not planning to go ahead in the future, but are proceeding with the project on its own merits at this time, not because of the benefit of some sort of subsidy. Tesoro has an unblemished record in dealing with the state on its existing contract.

<u>Senator Fahrenkamp</u> stated that estimates of the price break for a processor buying royalty oil from the state run from one to three dollars per barrel, and asked if a long-term contract would result in cost reductions passed on to consumers.

Mr. Jurin replied that he didn't know what the future price situation would be; the cost of raw materials is not the only factor. A long-term contract would mitigate abrupt shortages in supply which have been brought on in the past by economic supply shortages, requiring that Tesoro reduce production runs. Tesoro will do whatever possible to maintain the competitive or below market pricing.

In response to Rep. Halford, Mr. Jurin stated that Tesoro currently supplies 27 to 28 percent of the market directly, with the remainder being supplied by Chevron, Union, Texaco and independent operators. Tesoro will probably never supply the whole state, due to competive differentials in transportation costs. Tesoro serves mainly the lower railbelt and Kenai area. They provide 78 percent of the turbine fuel to the Anchorage International Airport, and will probably supply more with an arrangement for another hydrocracker plant. The potential loss to the state by the west coast offset may change; the gulf coast prices have been traditionally higher that the west coast. Tesoro would not be looking for a long-term contract if they thought that there would be an ample future supply of oil. Projections predict that there will be more shortages than surpluses over the long run.

In response to Rep. Cotten, Mr. Jurin stated that Tesoro has a contract with San Deigo Gas and Electric to purchase the return oil. The contract began in 1972, and has been renewed through 1984. Tesoro intends to expand their facilities to process the return oil. They don't have a guaranteed market in the pipeline.

Jim Smith, President, Tesoro Alaka Crude Oil Company, in response to Rep. Cotten, stated that whether the price Tesoro would pay for oil would be greater than the average weighted price, if they purchased it from a producer other than the state depends upon variable market conditions. Tesoro is currently buying ANS crude from Sohio on the spot market, probably paying more than they would pay other producers, but the other producers are not willing to sell.

The Committee was adjourned at 9:50 a.m.

Alaska State Legislature

SENATE
Resources Committee

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MEMBERS PRESENT

Senator Fahrenkamp
Senator Eliason
Senator Gilman
Senator Mulcahy
Senator Sturgulewski

April 7, 1982
3:10 p.m.

Beltz Room
Room 211 - Capitol

Hearing:

SB 880 Sale of royalty oil by the State of Alaska to Doyon, Ltd.
SB 881 Sale of royalty oil by the State of Alaska to Tesoro Alaska Petroleum.

Senator Fahrenkamp explained that the Committee was to either accept or reject the contracts, but could not amend them.

SB 881

Dennis Jurin, President, Tesoro Alaska Petroleum Company, spoke in support of SB 881, stressing that projections predict that over the long run there will be more shortages of oil than surpluses. Although crude oil prices are very difficult to predict even for the short term, Jurin was confident that the selling of oil in kind would not result in depreciation of the State's revenue. He reviewed his company's "good track record" and the direct positive economic impact they continue to have on the state. He concluded by stating his company's need for a long-term, stable supply of crude oil to continue refinery operations.

Senator Mulcahy moved SB 881 and asked unanimous consent.

SB 880

John Katz, Commissioner, Department of Natural Resources, described two items of concern in the Doyon contract. One is the four year waiver on option fees, which is an incentive to new entry but may be anti-competitive. The other is Doyon's lack of financing. Katz suggested that the Committee has three options: to approve the contract, disapprove the contract, or approve the contract contingent on a finding by the Commissioner of the Department of Natural Resources that, by a date certain, financing is firm and adequate, and that all other essential aspects of the program have been maintained.

AGO 786298