

Best Interest Finding and Determination

For the Sale of

Alaska North Slope Royalty Oil

To

Flint Hills Resources Alaska, LLC



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

**550 West 7th Avenue, Suite 800  
Anchorage, Alaska 99501-3510**

**February 12, 2004**

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## Executive Summary

The Department of Natural Resources has negotiated a proposed ten-year contract to sell the State's North Slope royalty oil to Flint Hills Resources Alaska, LLC (FHR). FHR is negotiating the purchase of the assets of Williams Alaska Petroleum, Inc. including its refinery at North Pole, Alaska. This document summarizes the terms of the State's royalty oil sale contract and describes the criteria and considerations underlying the determination that this sale of royalty oil in-kind (RIK) is in the State's best interest.

### UNDER THE PROPOSED CONTRACT FLINT HILLS RESOURCES WILL BE OBLIGATED TO MEET THE FOLLOWING TERMS:

- **Price**

FHR will pay a price calculated using the following formula:

$$\text{ANS Spot Price} - \$1.55 - \text{Tariff Allowance} + \text{Quality Bank Adjustment} - \text{Line Loss}$$

DNR forecasts the future additional royalty revenues under the proposed contract to be \$0.30 per barrel or approximately \$2.6 million to \$8.4 million per year.

- **Special Commitments**

As additional consideration for the RIK purchase, FHR agrees to:

1. Invest approximately \$100 million to install clean fuels processing equipment and facilities in the North Pole Refinery and/or elsewhere in Alaska.
2. Fulfill and enhance the previous commitments made by Williams Alaska Petroleum Inc. to the Government Hill Community Council in Anchorage to address concerns about gasoline storage tanks near Government Hill and undertake additional projects to improve the Anchorage Tank Farm facility.
3. Continue to ship refined products to Anchorage via the Alaska Railroad.
4. Study the use and viability of the hydrant fueling system at the Fairbanks International Airport (FIA), concentrate on promoting FIA to cargo carriers, evaluate and possibly upgrade FIA fuel distribution facilities, and charge a jet fuel customer in Fairbanks the same or lower price as FHR charges that same customer in Anchorage.
5. Maintain the wholesale truck rack prices for gasoline in Fairbanks at a price not to exceed the wholesale truck rack prices for gasoline in Anchorage.

- **In-State Processing**

FHR will make all commercially reasonable efforts to insure that the royalty oil it purchases under this contract will be processed at the North Pole Refinery or exchanged for oil that will be processed at the North Pole refinery. FHR's substantial investments, both in purchase of the North Pole refinery and in its contractual agreement to invest in Clean Fuels facility upgrades, further ensure the continued long-term prospects for in-state refining of State royalty oil.

- **Local Hire**

FHR agrees to employ Alaska residents and Alaska companies.

IN RETURN FOR THESE PROVISIONS THE STATE WILL PROVIDE:

- **Quantity**

The State agrees to sell to FHR ANS royalty oil within the range of 24,000 to 77,000 barrels per day, or nearly FHR's total refinery requirements, for the ten-year contract term. The State may limit the amount of oil sold to not more than 85 percent of the State's total North Slope royalty oil.

- **Term**

The term of the contract is ten years.

## **I. Introduction**

The commissioner of the Department of Natural Resources (DNR), on behalf of the State of Alaska, has negotiated a long-term contract to sell the State's North Slope royalty oil to Flint Hills Resources Alaska, LLC (FHR) and Flint Hills Resources, Inc. (as guarantor), both of which are subsidiaries of Koch Industries, Inc. FHR has executed a contract for the purchase of the assets of Williams Alaska Petroleum Inc. (Williams) including Williams' North Pole refinery. FHR's contract with Williams is contingent on FHR's successful negotiation of a ten-year contract for purchase of State North Slope royalty oil to provide feedstock for the refinery.

The State proposes this sale of RIK oil to relieve market conditions for crude oil to meet in-state needs. The negotiations that have resulted in the attached proposed contract have been carried out under the procedures for a non-competitive disposition of royalty oil set out in 11 AAC 03.024. Under the terms of this contract the sale price for the royalty oil will exceed the amount the State would have received by taking its royalty oil in-value.

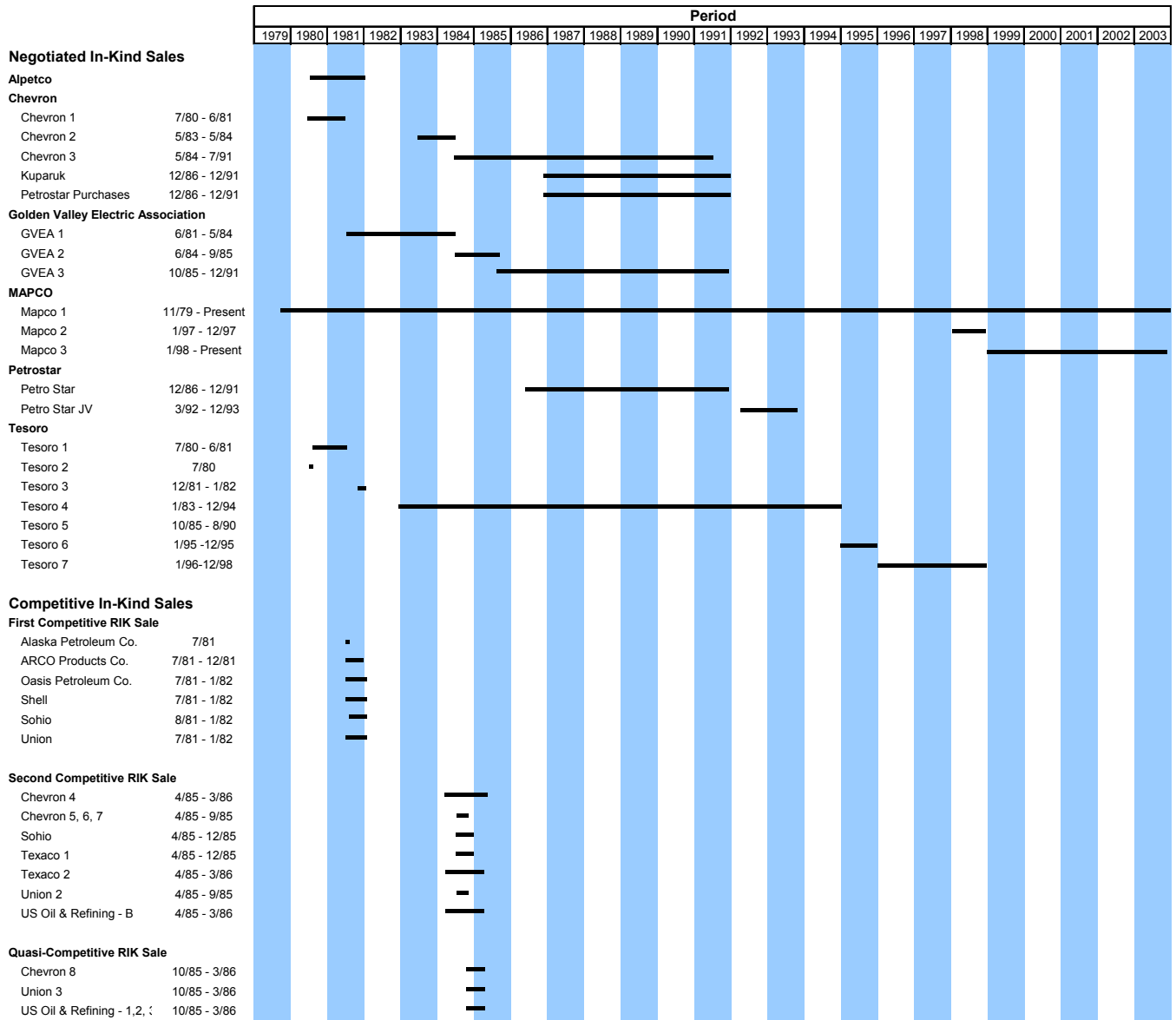
From an in-depth consideration of the potential economic, environmental, and social impacts, and the various requirements for sale of the State's royalty oil, with a focus on the criteria specified under the terms of AS 38.05.183(a) and (e) and AS 38.06.070(a), the commissioner finds that a negotiated long-term contract for the sale of the State's royalty oil to FHR is in the State's best interest.

## **II. Background**

The State of Alaska owns the mineral estate, including oil and gas, under State-owned lands. It has entered into lease agreements with third parties who explore for, develop, and produce oil and gas from these lands. The State receives a royalty share of 12.5 to as much as 33-1/3 percent of the oil and gas produced from these leased lands, which it may take either "in-kind" (RIK) or "in-value" (RIV). When the State takes its royalty as RIV, the lessees who produce the oil market the State's share along with their own production and pay the State the value of its royalty share. When the State takes its royalty share of the oil as RIK, it assumes ownership of the oil, and the commissioner disposes of it through sale procedures designated either "competitive" or "non-competitive" under AS 38.05.183.

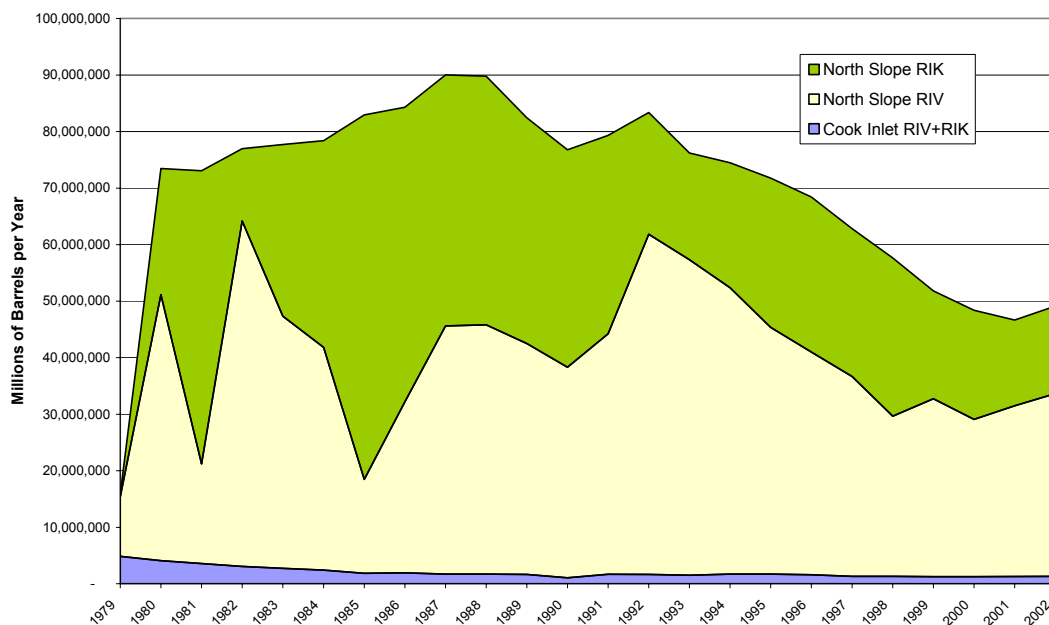
Over the years the State has sold nearly half of its royalty oil to in-state refineries, and occasionally has auctioned its royalty oil to customers in the Lower 48. Figure 1 summarizes the many North Slope RIK contracts since 1979 and Figure 2 illustrates the average annual volumes of royalty oil committed to these contracts during this period.

**Figure 1: Major North Slope Royalty in-Kind Sales Contracts  
1979-2003**



**Figure 2: Composition of Total North Slope Royalty Dispositions  
1979-2003**

**Royalty in-Kind (RIK) and Royalty in-Value (RIV)**



### A. The Current Royalty In-Kind Contracts with Williams

When the Prudhoe Bay field began production, the State entered a 25-year contract to sell North Slope royalty oil to Earth Resources, Inc. who later built the refinery at North Pole, Alaska. The 25-year Earth Resources royalty oil contract supplied the North Pole refinery with an average of 35,000 barrels of royalty oil per day and was eventually assigned to Mapco Alaska, Inc. In 1997, the State and Mapco Alaska, Inc. negotiated a one-year contract for approximately 13,000 barrels per day to augment the supply of royalty oil delivered under the 25-year contract. In 1998, the State and Mapco “extended” this one-year contract by negotiating a new five-year contract that was subsequently approved by the Legislature. This five-year contract provided an average of 22,800 barrels per day in addition to the 35,000 barrels per day delivered under the old 25-year contract. Later in 1998 Mapco sold its Alaskan assets and assigned both the 25-year contract and the 5-year contract to Williams. Under these contracts, the State was obliged to deliver only royalty oil produced from the Prudhoe Bay Unit. These two contracts expired on December 31, 2003.

Following the expiration of the 1978 and 1998 RIK contracts on December 31, 2003, the State has continued to supply the North Pole refinery with royalty oil for feedstock under a short-term contract between the State and Williams that will expire on March 31, 2004.<sup>1</sup> The State has

<sup>1</sup> See Alaska Department of Natural Resources. October 1, 2003. “Best Interest Finding and Determination for the Sale of Alaska North Slope Oil” for a copy of this short-term contract.

executed a second short-term RIK contract with Williams to provide the refinery with an uninterrupted supply of royalty oil through September 30, 2004<sup>2</sup> to enable the continued operation of the refinery while the Department of Natural Resources and FHR conclude their negotiations on the proposed RIK contract that is the subject of this Finding and Determination. The two short-term RIK contracts are required to accommodate the nomination procedures required under the State leases, unit agreements, and the royalty settlement agreements between the State and the North Slope producers. The leases and agreements require the State to nominate the monthly quantity of royalty oil it elects to take in-kind 90 to 180 days before the production month for which the RIK nomination is made. The State must therefore execute its RIK sale contracts three to six months in advance of the month of first delivery in order to limit State nominations to quantities that are the contractual obligation of the ultimate RIK purchaser. Thus, the State's second short-term contract with Williams for deliveries to the North Pole refinery beginning April 1, 2004, was required to be executed prior to January 1, 2004.

The short-term contracts obligate Williams to take RIK oil that the State will nominate before the conclusion of Williams' refinery sale to FHR and the execution of the State's proposed RIK contract with FHR. The proposed RIK contract with FHR can not become effective until DNR (1) publishes the commissioner's findings on whether the contract serves the best interests of the State; (2) convenes the Alaska Royalty Oil and Gas Development Board ("Royalty Board") to review the contract (11 AAC 03.020); and (3) receives approval for execution of the multi-year contract from the Legislature. After the sale of the refinery is completed and provided that the State's long-term RIK contract with FHR receives all required approvals, FHR will take over the operation of the North Pole refinery and the RIK oil nominated under the short-term Williams' contracts will be assigned to FHR. FHR will pay for the RIK oil assigned to it under the terms (including price) set forth in the proposed long-term RIK contract.

## **B. RIK Oil Sale Procedure**

Before executing a contract for the disposition of royalty oil in-kind, the commissioner must find that the disposition is in the best interests of the State. The commissioner establishes the terms, conditions, and methods of disposition of the State's royalty oil that is taken in-kind. The oil may be sold under "competitive" or "non-competitive" procedures. RIK oil may be sold under the "non-competitive" procedures, if the commissioner determines that the best interest of the State will be served by a non-competitive sale. (AS 38.05.183(a)). In making this determination, the commissioner must consider the criteria listed in AS 38.05.183(e) and AS 38.06.070(a). The RIK contract must be awarded to the prospective buyer whose proposal offers maximum benefits to the citizens of the State.

In March of 2003, Williams met with staff at the Division of Oil and Gas and requested a new five-year RIK contract to fully supply the North Pole refinery feedstock requirements following expiration of the 1978 and 1998 RIK contracts. Williams informed the State that it was actively seeking to sell its Alaska assets and intended to assign the proposed RIK contract to the purchaser of the North Pole refinery. In early July 2003, FHR met with the Governor and his staff and indicated that it intended to buy the Williams' North Pole refinery and that a long-term

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<sup>2</sup> See Alaska Department of Natural Resources. December 29, 2003. "Best Interest Finding and Determination for the Sale of Alaska North Slope Oil" for a copy of this second short-term contract.



contract with the State would make it possible for FHR to upgrade the properties it would acquire. The Governor called a meeting for July 29, 2003, and invited all potential in-state purchasers of North Slope RIK to discuss what terms each company might offer the State.

As a result of these meetings, and after consideration of all the criteria of AS 38.05.183(e) and AS 38.06.070(a), the commissioner determined that FHR was the prospective buyer whose proposal offered the maximum benefits to the citizens of the State, and agreed to negotiate an RIK contract directly with FHR. Individual findings on each of the statutory criteria are set out in Sections IV and V, below.

The commissioner determined that the sale of RIK oil to FHR would relieve market conditions by providing crude oil required for the continued operation of the North Pole refinery. In addition, the State would benefit from a sale price throughout the term of the long-term contract that would be higher than the volume-weighted average of the reported netback prices applicable to royalty oil taken in-value for the same period. The commissioner concluded, on balance, that entering into a long-term RIK sale contract with FHR, on the terms and conditions as included in the attached proposed contract, is in the best interests of the State.

This Best Interest Finding and Determination and a copy of the proposed RIK contract are available from the State by contacting:

Division of Oil and Gas  
Attn: Kevin Banks  
550 W. 7th Ave, Suite 800  
Anchorage, Alaska 99501  
Phone: (907) 269-8781  
E-mail: krb@dnr.state.ak.us

and will also be published on the Division of Oil and Gas website at:

<http://www.dog.dnr.state.ak.us/oil/>

A copy of the proposed RIK oil sale contract is attached as an appendix to this Best Interest Finding and Determination.

### **III. Discussion Contract Provisions**

The proposed contract represents an evolution of RIK contract terms of the most recent (1998) State RIK contract with Williams as modified through negotiations between the State and FHR. The 1998 RIK contract with Williams is the latest in a 25 year history of long-term contracts between the State and the in-state refineries. This section is a summary of the essential terms of the proposed contract.

## A. Price (Section 2.3 and Appendix 2)

The price per barrel of the royalty oil sold to FHR is set each month and is defined by the equation:

$$\text{ANS Spot Price} - \$1.55 - \text{Tariff Allowance} + \text{Quality Bank Adjustment} - \text{Line Loss}$$

Each of the elements of this equation are explained below:

### 1. ANS Spot Price

The ANS Spot Price is a monthly average of the daily average prices reported by three industry trade publications: Platt's Oilgram Price Report, Telerate online data reporting service, and Reuters online data reporting service. The ANS Spot Price represents the market value for North Slope oil sold on the U.S. West Coast. Judging by the prevalence of its use among the many buyers and sellers of North Slope oil, the use of the ANS Spot Price as defined in the proposed RIK contract is a credible and reliable measure of the ANS market. The Alaska Department of Revenue has adopted a similar definition for use in its calculation of Prevailing Value for production tax purposes.

The FHR contract contemplates the possibility that one or more of these reporting services may fail to publish a market price for North Slope oil or that the ANS Spot Price may no longer accurately represent the price for North Slope oil in the U.S. West Coast. In the first case, the ANS Spot Price will be calculated by using data from the remaining reporting services. In the second case, FHR and the State will attempt to arrive at a mutually agreeable alternative source of data to determine the ANS Spot Price.

### 2. \$1.55 per Barrel Deduction

Unlike former long-term RIK contracts between the State and in-state refinery customers, the proposed FHR contract does not directly reference the RIV netback value in the price term. The flat \$1.55 per barrel deduction from the ANS Spot Price replaces the actual (adjustable) marine transportation cost factor included in former RIK contracts. This is a deduction that FHR makes to its price paid for RIK oil, and thus the smaller the deduction, the higher the price paid by FHR to the State.

The \$1.55 deduction provides a premium to the State compared to DNR data on the deduction for marine transportation costs for the last three years allowed in the royalty settlement agreements with the lessees to calculate the RIV netback. The RIV netback is subject to change as the lessees are audited and when a current marine transportation cost "reopener" with ExxonMobil is resolved.<sup>3</sup> DNR's estimate of the deduction for marine transportation costs for

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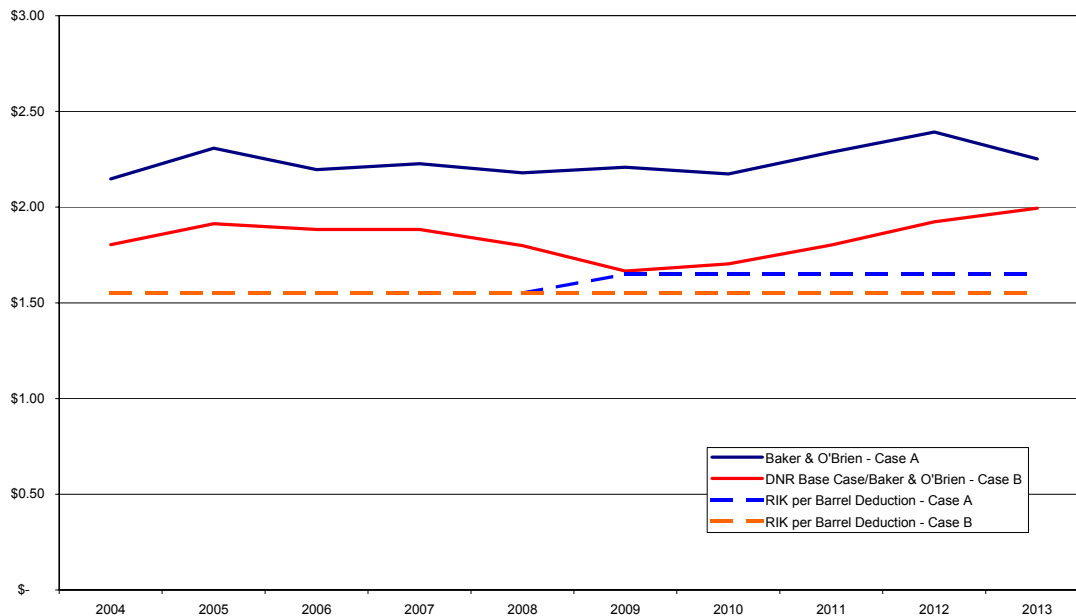
<sup>3</sup> Each of the royalty settlement agreements with the North Slope lessees provides opportunities for the State or the lessee to renegotiate elements of the RIV netback formula. The State and ExxonMobil are currently disputing the calculation of ExxonMobil's destination value, marine transportation cost deduction, and the deduction for line losses.

the last three years allowed in the royalty settlement agreements ranges from \$1.73 to \$1.92. Based on a somewhat optimistic view of where the State may end up when the RIV netback is finally determined, DNR concluded that the difference between the RIV deduction for marine transportation and the RIK \$1.55 per barrel deduction yielded a premium of \$0.30 over this three year period.

The \$1.55 per barrel deduction is subject to revision at the end of year five of the proposed contract term. The revision will be calculated as follows: First, the State will take an average of the deduction for marine transportation costs for years 3, 4, and 5 of the contract term used to calculate the RIV netback. Second, subtract \$0.30 from this average. If the result is less than \$1.45 per barrel, then the RIK per barrel deduction for the years 6-10 will be \$1.45. If the result is greater than \$1.65, the RIK per barrel, then the RIK per barrel deduction for years 6-10 will be \$1.65.

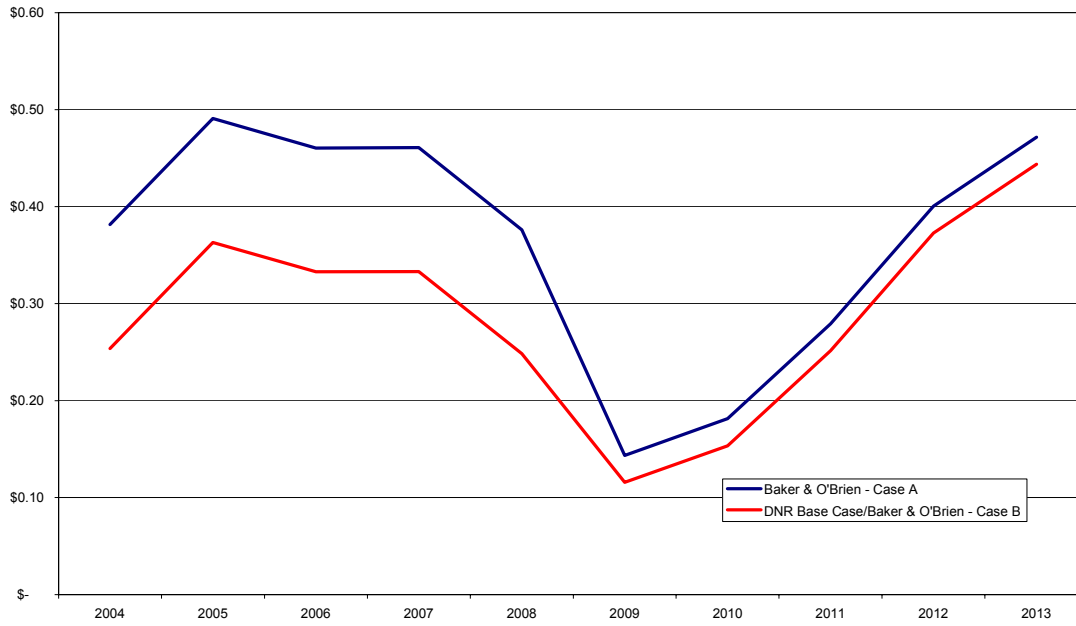
DNR prepared a forecast of the RIV deduction for marine transportation costs for RIV and retained Baker & O'Brien to review the methodology used by DNR.<sup>4</sup> The results of this work are shown in Figure 3 and 4. Two forecasts are illustrated and both employ a hypothetical revision of the RIK per barrel deduction after year five of the proposed contract. The DNR base case suggests that the proposed contract will yield an average premium of about \$0.30 per barrel over the RIV netback for the ten-year term of the contract. Baker & O'Brien's Case A suggests that the proposed contract will yield a premium of \$0.36 per barrel. The difference in these two forecasts is explained by the different predictions DNR and Baker O'Brien assumed about the outcome of the current reopener dispute with ExxonMobil.

**Figure 3: RIV Marine Transportation Deduction Versus RIK Differential**



<sup>4</sup> Dileep Sirur, Baker & O'Brien, Inc., Dallas, TX. Personal Communication, December 22, 2003.

**Figure 4: RIK Contract Premium**



### 3. Tariff Allowance

The Tariff Allowance provides an additional deduction from the ANS Spot Price equal to the average cost of pipeline transportation paid in transporting ANS oil to the spot markets on the U.S. West Coast. It is calculated as the sum of the ownership-weighted average minimum interstate TAPS tariff filed for each of the TAPS owners, plus any tariffs paid by FHR for shipment of royalty oil on pipelines on the North Slope upstream of Pump Station No. 1. Buyers and sellers in the Alaska market generally set contract prices in recognition that Alaska sales are an alternative to interstate shipments to the U.S. West Coast, and pricing terms are set accordingly.

All prior State RIK contracts for ANS oil have provided oil from the Prudhoe Bay Unit. Under the proposed contract with FHR, the State has the option of providing royalty oil from any ANS production unit, and the additional allowance for tariffs paid on pipelines upstream of Pump Station No.1 is a reimbursement of FHR's additional tariff costs incurred due to the State's choice of production unit. The State will also provide line fill for these upstream pipelines; i.e., the inventory of barrels delivered and sold under the terms of the proposed contract will be tracked in such a way that FHR will take delivery of barrels counted at the inlet of the pipelines but pay for the barrels counted at Pump Station No. 1. These terms will make FHR indifferent to the State's selection of the production unit from which the RIK oil is provided. In return, the

State has the freedom to maximize value by judiciously nominating royalty oil from different combinations of North Slope production units.

The Tariff Allowance is one of the elements of the price term in the proposed contract that is subject to retroactive adjustments. The Tariff Allowance may be adjusted if the tariff used in the calculation of the Tariff Allowance at the time of FHR's payment is changed (or subject to a refund order) by the Federal Energy Regulatory Commission (FERC) at a later date.

#### 4. Quality Bank Adjustment

The Quality Bank Adjustment is a positive or negative number that reflects the value of different streams of oil that are shipped in TAPS. The Quality Bank is administered by the owners of TAPS and regulated by the FERC. Oil tendered for shipment at Pump Station No. 1 is produced from several different production units and the shippers of oil of lesser value must reimburse the shippers of oil of greater value for the degradation of value of the co-mingled mixture of oil. Similarly, the refineries in North Pole and Valdez also take oil out of TAPS, extract the valuable components of the oil in manufacturing petroleum products, and re-inject into the pipeline a mixture of lower valued components. The return streams from the refineries bear a quality bank payment to each of the owners of the passing TAPS stream.

The Quality Bank Adjustment in the proposed contract is calculated as the difference of the value of royalty oil where it is tendered at the point of sale—either at Pump Station No. 1 or at the entry into a pipeline upstream of Pump Station No. 1—and the value of the oil in TAPS downstream of the PetroStar Valdez refinery. Appendix 2 in the proposed contract provides an example for how the Quality Bank Allowance is calculated for RIK oil produced at the Duck Island Unit and processed in the unit's Endicott Main Production facilities. The State may readjust the Quality Bank Allowance if the Quality Bank administrator recalculates one of the values used in the calculation of the Quality Bank Allowance. After six months the only retroactive adjustments of the Quality Bank Allowance that may occur are those that result from a direct order issued by the FERC.

#### 5. Line Loss

Line Loss is a per barrel amount equal to

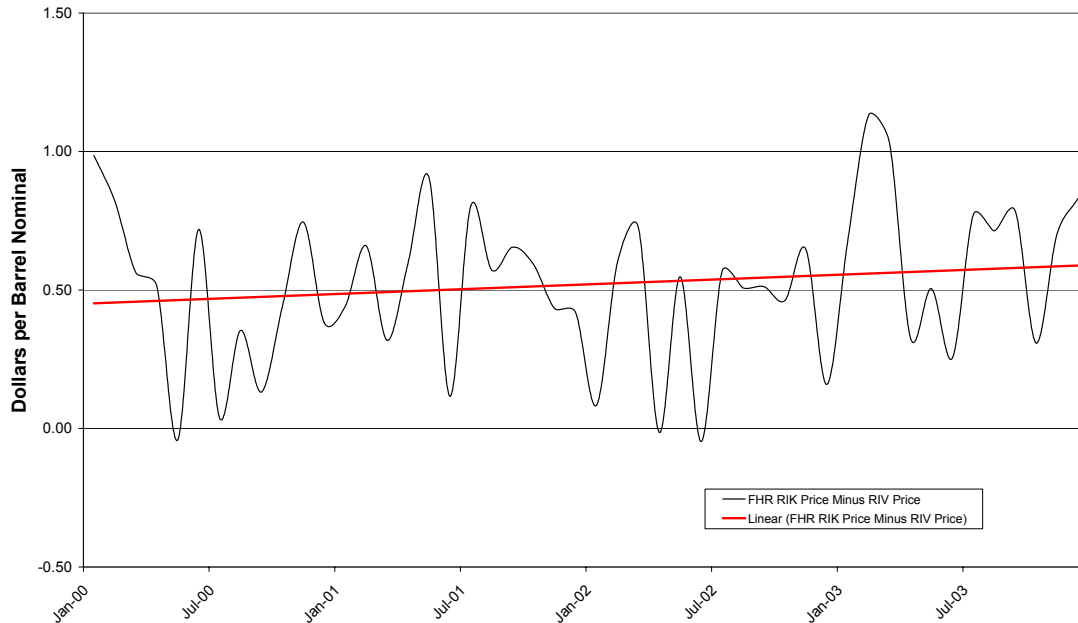
$$(.0009) \times (\text{ANS Spot Price} - \$1.55 - \text{Tariff Allowance} + \text{Quality Bank Adjustment}).$$

This term accounts for the minor change in the volumes of oil delivered at Valdez caused as compared to the volumes tendered at Pump Station No. 1. A line loss element also appears in the netback formulas in the royalty settlement agreements.

In summary, the price term in the proposed contract provides a mechanism that replaces the RIV netback formulas embedded in the price term of former RIK contracts. On the basis of the difference between the deduction for marine transportation costs in the RIV netback and the \$1.55 per barrel deduction in the proposed contract, the State will realize a premium of \$0.30. This represents a conservative estimate of the value of the proposed contract. There are

differences in other elements of the RIV formulas that may also contribute to additional benefits for the State. The calculation of the destination value in the RIV netback and the ANS Spot Price in the proposed contract is one element in each formula that may be the source of an additional premium for the State. Figure 5 shows a historical comparison between the RIV netback value at Pump Station No. 1 and the RIK price. If the proposed contract were in place in 2000-2003, the State would have earned \$0.52 per barrel more than RIV netback value.<sup>5</sup>

**Figure 5: Backcast of Proposed FHR RIK Contract Price  
Difference from RIV Netback**



## B. Special Commitments (Article V and Appendix 4)

Appendix 4 of the contract lists the Special Commitments agreed to by FHR. These commitments are listed here followed by a brief explanation.

### 1. Clean Fuels Processing

After performing an engineering study, FHR will install necessary equipment and complete such modifications to its North Pole Refinery, or will participate in the modification of other refinery facilities in Alaska, as required to produce gasoline and on-road, off-road, marine, and rail diesel fuels that meet or exceed all U.S. Environmental Protection Agency (“EPA”) low sulfur fuel requirements (“Clean Fuels”). FHR will make commercially reasonable efforts to complete necessary installations and modifications on or before the effective dates of the Clean

<sup>5</sup> A comparison between the proposed contract price and the price paid by Williams over the same time period (2000-2003) yields a premium of \$0.46 per barrel. Williams’ 25-year contract price is equal to the RIV netback; Williams’ 1998 contract price is equal to the RIV netback price plus \$0.15 per barrel.

Fuels requirements of the EPA regulations. These projects will result in a significant reduction in gasoline and diesel sulfur levels.

The EPA Clean Fuels regulations require that U.S. refineries must supply low-sulfur on-road diesel by June 2006.<sup>6</sup> Low sulfur diesel must be available for new heavy-duty vehicles equipped with emission control devices that will be introduced in the 2007 model year, i.e., the fall of 2006. Low sulfur “Tier 2” gasoline and non-road diesel must be supplied by 2010.

FHR's total project costs are expected to exceed \$100 million and will likely include the construction of processing units, including hydrotreating, a hydrogen plant and sulfur removal equipment. The construction project will have a significant, though temporary, impact on the local and State economy. Most of the equipment to be installed will be manufactured outside of Alaska, and so the personal income and employment effects will be generated by the construction activities on-site and will depend on the availability of skilled workers who are residents of Alaska.

In a study provided by Anadarko Petroleum, Inc. and EnCana Oil and Gas (formerly AEC Oil and Gas, Inc.) in support of their 2002 proposal to buy North Slope royalty gas the proportion of in-state expenditures to total expenditures for the development phase of their North Slope Foothills project was approximately 46 percent.<sup>7</sup> This suggests a conservative estimate of \$40 million for in-state expenditures could apply to FHR's Clean Fuels projects. This same study also indicated that the largest in-state development cost item was personnel expenses at 20 percent of total. If the Anadarko study is any indication, FHR's project will inject \$20 million into the State economy in the form of wages and salaries. Applying the Anadarko analogy to the FHR Clean Fuels projects, DNR estimates 100 to 200 direct jobs during construction with possibly twice that for indirect jobs.<sup>8</sup> To the extent that FHR's preferred strategy to produce Clean Fuels in Alaska will involve improvements at the North Pole refinery these construction jobs will occur in the Fairbanks North Star Borough and the central Alaska region.

Impacts on local and statewide employment and personal income from construction will be temporary. Incremental long-term employment and personal income effects generated by the Clean Fuels projects at North Pole of the refinery should be rather small.<sup>9</sup>

## 2. Anchorage Tank Farm Evaluation.

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<sup>6</sup> 40 CFR Parts 69, 80, 86. Diesel fuels must meet a 15 parts per million sulfur standard. Under current EPA regulations, diesel fuels must meet a 500 ppm sulfur standard.

<sup>7</sup> Northern Economics, Inc. January 2002. “Economic Impacts of Anadarko Exploration, Development, and Production of Alaska North Slope Foothills Gas Operations” p. 2-7.

<sup>8</sup> Additional support for the estimate can be found in the number of construction jobs generated by a 1995 expansion project conducted by Tesoro Alaska Petroleum Company at its Nikiski, Alaska refinery. Installation of a \$26 million vacuum unit upgrade generated 180 direct and indirect jobs. Alaska Department of Natural Resources. September 1995. “Final Finding and Determination to sell Royalty Oil to Tesoro Alaska Petroleum Company” p. 18.

<sup>9</sup> In 1998 Williams Alaska Petroleum, Inc. invested in a \$70 million expansion of the North Pole refinery. Williams indicated that the expansion created 17 new jobs. Alaska Department of Natural Resources. March 1998. “Final Finding and Determination to Sell Royalty Oil to MAPCO Alaska Petroleum Alaska, Inc.” p. 13.

FHR agrees to discharge the commitments previously made by Williams in the “Memorandum of Agreement between Williams Alaska Petroleum, Inc. and The Government Hill Community Council” (attached as Appendix 6 to the proposed contract). The key requirements are as follows:

- a. Remove three (3) tanks from east of the Ocean Dock Road with a total capacity of over 5,500 barrels;
- b. Refrain from installing additional tanks east of the Ocean Dock Road;
- c. Evaluate all remaining tanks east of the Ocean Dock Road to determine whether they comply with all State and Federal requirements for overfill protection, fire protection, tank seal monitoring, potential for change of product service, and possible removal of additional tanks, and prompt remediation of any violations of these requirements;
- d. Installation of new tanks west of the Ocean Dock Road will occur provided that existing tanks on the east side of Ocean Dock Road are retired and removed on a tank-for-tank basis; and
- e. Continue cooperative efforts in connection with the ongoing Bulk Fuel Hazard Study currently underway through the Municipality of Anchorage.

### 3. Shipment by Rail.

Williams currently ships refined products by rail under contract with Alaska Railroad Corporation (an Agreement originally entered by MAPCO Alaska Petroleum Inc. in May of 1993). Williams transported about 1.4 million gallons per day of jet fuel during 2001, plus naphtha, and about 3,000 barrels per day of gasoline by rail to south central Alaska. As part of FHR’s refinery acquisition from Williams, FHR will assume the rights and obligations of Williams under the rail agreement and continue to ship refined products to Anchorage through the term of its current railroad contract until 2013.

### 4. Fairbanks International Airport.

The proposed contract requires FHR and the State to jointly explore commercially reasonable options for increasing passenger and cargo air traffic through the Fairbanks International Airport (FIA), with a focus on promoting the FIA to cargo carriers operating between Asia and Europe. FHR shall also evaluate the airport’s fuel distribution facilities and the feasibility of using or upgrading the existing hydrant fueling system.

Alaska’s three refineries supply all of the in-state jet fuel consumed at the international airports in Anchorage and Fairbanks, and at military bases in the state.<sup>10</sup> The North Pole refinery is the largest producer of jet fuel in Alaska. It accounts for about two thirds of total jet fuel consumption, as shown in Table 1.<sup>11</sup> While the North Pole refinery accounts for more than half of the Anchorage jet fuel consumption, the Fairbanks International Airport will remain an important jet fuel market for FHR.

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<sup>10</sup> Jet fuel is generally not imported into Alaska unless unusual circumstances arise, such as the West Coast longshoremen strike of mid 2002, which resulted in greater-than-usual air cargo activity.

<sup>11</sup> Dileep Sirur, Baker and O’Brien, Inc., Dallas, TX. Personal Communication. November 11, 2003.



**Table 1: Regional Composition of Jet Fuel Production by Refinery**

(Barrels per Day)

	<b>TOTAL</b>	<b>Williams</b>	<b>PetroStar</b>	<b>Tesoro</b>	<b>Chevron<sup>12</sup></b>
Anchorage	52,000	29,000	3,400	13,600	6,000
Fairbanks	3,500	3,300	200	---	---
Military	5,100	1,400	3,700	---	---
<b>TOTAL</b>	<b>60,600</b>	<b>33,700</b>	<b>7,300</b>	<b>13,600</b>	<b>6,000</b>

The proposed RIK contract further provides for jet fuel price parity between Fairbanks and Anchorage. FHR has agreed that it will charge a jet fuel customer at the Fairbanks International Airport the same or lower jet fuel price as FHR charges that customer at the Anchorage International Airport.

#### 5. Wholesale Gasoline Rack Price Parity

FHR agrees, for the term of the proposed contract, to maintain its wholesale truck rack posted price for gasoline in Fairbanks at a price not to exceed its wholesale truck rack posted price for gasoline in Anchorage on an annual simple average basis (within a tolerance/variation of 1 cent per gallon (cpg)). If the annual average variation of these posted prices exceeds 1 cpg, FHR will, in the first 90 days of the following year, reduce the variation below 1 cpg, averaged over the year-plus-90-day period. This provision will not apply to gasoline exchanges.

A review of OPIS wholesale gasoline truck rack price show that for the period January 2000 through October 2003, Fairbanks prices averaged 1.5 cpg lower than Anchorage prices for regular and premium grades.<sup>13</sup> These are wholesale prices, not prices that consumers pay at the pump. Furthermore, posted prices do not necessarily reflect prices realized in actual transactions. Discounts (also known as “Temporary Competitive Allowances” or “TCAs”) are offered about two or three times per year, but can last for extended periods and are offered to just a few customers.

A significant volume of gasoline is offered in exchanges between Williams and Tesoro. Williams provides approximately 500 to 600 barrels per day (21,000-25,000 gallons per day) to Tesoro in Fairbanks for an equal volume from Tesoro to Williams in Anchorage. Tesoro pays 4–5 cpg as an “exchange premium” for this arrangement because it can avoid the transportation charge to physically haul gasoline northbound on the Alaska Railroad. Tesoro’s incentive to participate in this exchange arises from the fact that Tesoro’s Nikiski refinery produces more gasoline than Tesoro can sell to its customers in the south central region. Tesoro’s alternatives to

<sup>12</sup> Chevron purchased jet fuel for re-sale from Williams under a 5-year contract.

<sup>13</sup> Dileep Sirur, Baker and O’Brien, Inc., Dallas, TX. Personal Communication, December 9, 2003. OPIS refers to the Oil Price Information Service, Rockville, Md. OPIS reports Alaska posted wholesale rack prices for only Fairbanks and Anchorage.

the exchange are to reduce gasoline production at the Nikiski refinery or to export the excess gasoline production at distressed prices. This suggests that the exchange premium paid by Tesoro is unlikely to put any upward pressure on the price of gasoline in Fairbanks relative to Anchorage. The effective cost to Tesoro at Fairbanks of the exchange is likely to be well below its Anchorage wholesale price plus the exchange premium.

The parity provision in the proposed contract will help to ensure that differences in pricing strategies between Fairbanks and Anchorage will not arise. Also, the parity provision will not adversely affect the exchange arrangements that contribute to supply efficiencies between the two communities that can benefit the consumer. On the other hand, the practice of using TCAs means that the parity provision will create transparency in the market at the expense of including all transactions.

**C. In-State Processing (Article IV)**

FHR will use “all commercially reasonable efforts” to process royalty oil purchased under the proposed contract in the North Pole refinery. FHR may exchange royalty oil for other crude oil that is also processed in the refinery. By comparison, in its 1998 contract Williams agreed to process at least 80 percent of the sale oil at its refinery in its current and prior RIK purchase agreements. Production capacity and processing equipment for the Williams’ refinery at North Pole is compared with other Alaska refineries in Table 2.

**Table 2: Alaskan Refinery Capacity**  
(Barrels per Stream Day)

<b>Company</b>	<b>Location</b>	<b>Atmospheric Crude Oil Distillation</b>	<b>Vacuum Distillation</b>	<b>Hydro- cracking</b>	<b>Reforming</b>
ConocoPhillips	Kuparuk	16,000	0	0	0
BP	Prudhoe Bay	14,200	0	0	0
Williams	North Pole	227,513	6,000	0	0
PetroStar	North Pole	18,000	0	0	0
PetroStar	Valdez	50,000	0	0	0
Tesoro	Kenai	80,000	19,800	9,050	12,000
<b>TOTAL</b>		<b>405,713</b>	<b>25,800</b>	<b>9,050</b>	<b>12,000</b>

As discussed above, the North Pole refinery is the largest in the state. It produces the following product slate:

Gasoline & Naphtha	19%
Jet Fuel	57
Diesel	19
Gas Oil	4
Asphalt	<u>1</u>
Total	100%

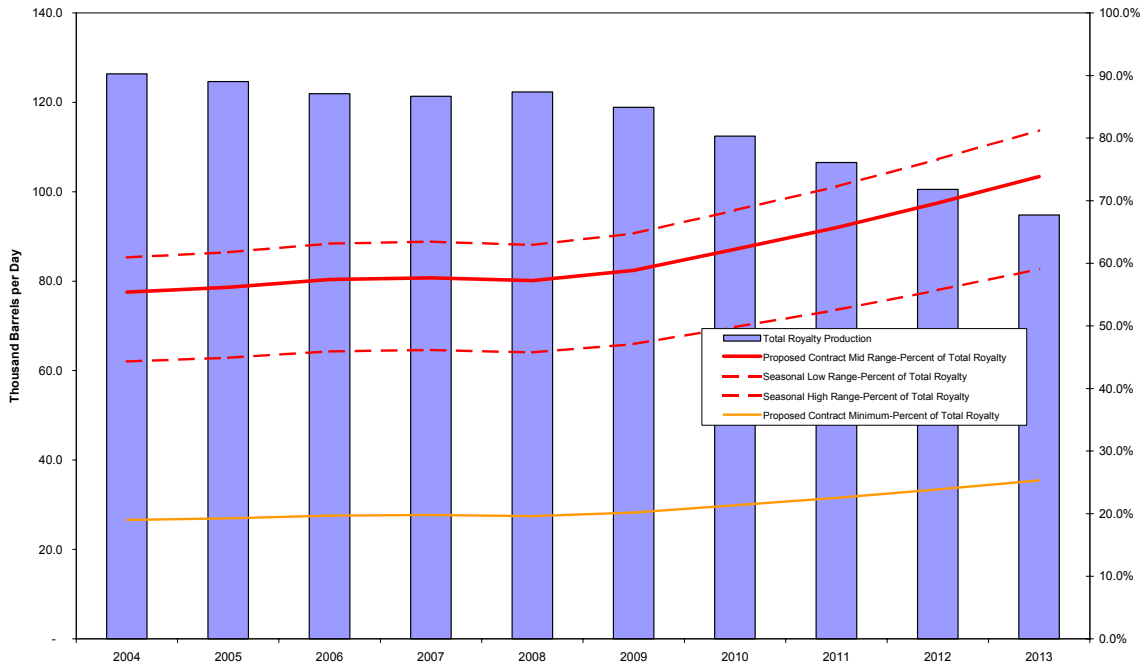
**D. Employment of Alaska Residents (Article XXIV)**

FHR agrees to employ Alaska residents and companies “to the extent they are available, willing, and at least as qualified as other candidates.”

**E. Quantity (Section 2.1)**

The FHR contract will initially provide between 24,000 to 77,000 barrels per day of royalty oil from the North Slope or nearly the total oil supply requirements of the North Pole refinery.<sup>14</sup> The range is intended to approximate the seasonal fluctuation in the refinery’s requirements. Based on DNR North Slope oil production forecast, the initial quantity will commit 44 to 62 percent of the State’s North Slope royalty oil to FHR in 2004. Owing to an anticipated decline in North Slope oil production over time, the initial contract quantity will likely equal between 59 and 82 percent of the State’s North Slope royalty oil by 2013. Figure 5 illustrates the State’s forecast of total North Slope Royalty oil and the percent of royalty oil committed to the FHR contract.

**Figure 6: Total Royalty Production and Proposed Contract Quantity  
Percent of Total**



<sup>14</sup> The range is equal to 80 percent and 110 percent of 70,000 barrels per day.

Even as these percentages may rise and/or fluctuate through time, the commissioner retains the right to limit the amount of the monthly royalty oil production supplied to the refinery to not more than 85 percent of total North Slope royalty oil or not more than 95 percent of the royalty oil produced from any single production unit.

FHR has the right to reduce the initial amount of royalty oil it takes under the contract after the first year of the contract following a six-month notice of the reduction. Additional reductions are allowed at intervals of not less than 12 months following the most recent reduction. FHR may not reduce below a minimum quantity to less than 24,000 barrels per day in the first five years of the contract term except for Force Majeure (see below) or a shut down of the refinery. During the second five years of the contract term FHR may reduce the quantity to zero, but otherwise the 24,000 barrels per day minimum remains.

FHR may also subsequently request an increase in the quantity of royalty oil 12 months after the most recent reduction. Approval of a requested increase will be in the discretion of the commissioner and the total quantity may never be increased above the initial contract quantity range.

In negotiating this quantity provision, DNR recognized that FHR sought to limit its exposure to major changes in the markets for its products. For example, should a change in jet cargo traffic occur in the next ten years because more efficient airplanes and routes are employed, FHR might reduce its manufacture of jet fuel and reduce its quantity of royalty oil. Under this scenario, the State would be able to sell the royalty oil once committed to FHR to buyers in other markets (or let the lessees take the royalty oil in-value). By the same token, the State did not want to provide FHR with the unbridled ability to arbitrage its royalty oil supply against the potential supply of oil from other North Slope producers. This situation would disadvantage independent North Slope producers (those producers without the marine transportation capability to sell oil Outside) whose “natural” market for their oil are the in-state refineries. Furthermore, unfettered ability to reduce the amount of oil taken by FHR has the potential of denying the State the potential revenue benefits of the contract.

By limiting changes in quantity to once every 12 months with six-month notice, the contract cannot easily set a cap on the value of North Slope oil sold in the state. The lead-time imposed by these requirements will make it somewhat difficult for FHR to find alternative suppliers unless those suppliers are willing to provide oil to FHR under long-term contracts. The minimum quantity requirement preserves for the State its price premium over RIV value on at least 24,000 barrels per day in the first five years of the contract. The discretion of the commissioner to refuse to increase the quantity once FHR has reduced it (as the commissioner would certainly do if the royalty oil were committed to another buyer) provides a disincentive for FHR to stop taking royalty oil in the second five years of the contract.

**F. Term (Article IX):**

From the start of negotiations FHR consistently held that it requires a ten year contract term in order to provide ten years of certainty of feedstock supply, if FHR was to commit to purchase of the North Pole refinery and major investment in clean fuels technology. Alaska statutes require that any contract for sale of State royalty oil be approved by the Alaska legislature if the contract term exceeds one year. The Governor is committed to have legislation introduced immediately following action on the proposed contract by the Royalty Board to provide for legislative approval of the total contract term of ten years. The proposed contract is drafted with a "one year plus nine year" term in order that the commissioner may execute the contract and FHR may proceed with its purchase and operation of the North Pole refinery during the interim period between the date of the Governor's signing of enacted legislation approving the proposed contract, and the effective date of the legislation 90 days later.

**G. Other Contract Provisions**

1. Invoicing and payment (Article III):

DNR will send monthly invoices and FHR will pay by the later of the third business day of the date of the invoice or the twentieth calendar day of the month. If adjustments are required after the initial payment and qualify under the price provisions, the State will send an invoice for the adjustment and FHR will pay by the later of the third business day or the twentieth of the month. Any amount not paid by the date required shall bear interest as required by AS 38.05.135(d), and will be subject to a penalty equal to five percent of the total amount not timely paid.

2. Security (VI and VII):

Flint Hills Resources Alaska, LLC is the buyer and the wholly owned subsidiary of Flint Hill Resources, LLC who is the guarantor under the proposed contract. The provisions of contract Articles VI and VII describe the obligation FHR Alaska, LLC as buyer, and FHR, LLC as guarantor, to pay amounts due and provide assurances of performance.

FHR, LLC will hire a Financial Analyst, approved by the commissioner to evaluate the financial health of FHR, LLC. Each year the Financial Analyst will render an opinion in the form of an Opinion Letter about FHR, LLC's current and future credit rating by Standard and Poor's and Moody's. The Opinion Letter will identify all documents reviewed in forming the opinion, identify people interviewed in forming the opinion, state the current long term and short term credit ratings of FHR, LLC, and express an opinion whether those ratings are likely to fall below a Standard and Poor's BBB+ or Moody's Baa1 rating.

If the opinion states that FHR's bond rating is likely to fall below those levels FHR must provide the State an irrevocable stand-by letter of credit issued for the benefit of the State in the principal face amount reasonably estimated by the commissioner to be equal to the price of all oil to be delivered during the 90 days immediately following notice of requirement for the letter. At \$26.00 per barrel, the price under the proposed contract using data for December 2003, and

average deliveries of 70,000 barrels per day, the face value of the letter of credit would be approximately \$165 million.

3. Dispute Resolution (Article XIII):

This provision sets out the process that the State and FHR will use should disputes arise. FHR and Alaska agree to accept the findings of the commissioner "...that are supported by substantial evidence in light of the whole record."

4. Force Majeure (Article XV)

The proposed contract provides relief for either party from a liability to perform if the performance is substantially prevented by Force Majeure. FHR is not relieved from its obligations to pay, provide assurances of its financial health, or accept royalty oil nominated for delivery under the quantity provisions of the proposed contract. Various Force Majeure events are described. If the Force Majeure event cannot be remedied in 180 days the commissioner may terminate the contract with sixty days notice.

#### IV. Analysis of State Benefits

Section IV sets out the commissioner's analysis of the benefits to the State from the proposed sale of ANS royalty oil to FHR, considering the criteria set out from AS 38.05.183(e) and AS 38.06.070(a).

**A. The cash value offered:**

The State considers the cash value of the proposed contract from two perspectives. First, the absolute magnitude of the future RIK revenues is based on the product of price and quantity provided in the proposed contract. The price is expected to range between \$16.60 and \$22.56 based on the Alaska Department of Revenue projections of the ANS spot price, Tariff Allowances, Quality Banks, and DNR's estimate for Line Loss.<sup>15</sup> The proposed contract stipulates a RIK quantity ranging between 24,000 and 77,000 barrels per day.<sup>16</sup> These upper and lower quantities translate to 44 and 62 percent of the State's total royalty share of production, respectively. Over time, as total ANS production declines, these RIK limits will increase, as a proportion of the total (to 69 and 82, respectively, in 2013).

These price and quantity provisions, combined with assumptions about the future spot price of ANS crude on the U.S. West Coast, imply annual total RIK revenues ranging from a low of \$198 million to a high of \$634 million, depending on quantity nominated, with an overall average of \$368 million.

The second cash value perspective looks to the incremental RIK revenue premium over the RIV alternative. As a non-competitive RIK sale to relieve "market conditions," the sales price throughout the term of the disposition must be higher than the volume-weighted average of

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<sup>15</sup> Alaska Department of Revenue, *Fall 2003 Revenue Sources Book*, Table 45 p. 35.

<sup>16</sup> The range is calculated as 70,000 plus 10 percent and minus 20 percent.

the current reported netback prices filed by lessees for royalty purposes. The price shown above implies a premium of approximately \$0.30 per barrel over revenues generated under RIV, based on DNR's forecast of the RIV alternative.<sup>17</sup> DNR forecasts the future royalty revenues under the proposed contract to be approximately \$2.6 to \$8.4 million per year above revenues if taken as RIV.<sup>18</sup>

**B. The projected effects of the sale, exchange or other Disposal on the economy of the State:**

In addition to the above described \$2.6 to \$8.4 million annual royalty revenue increase above the RIV alternative, the proposed contract will facilitate substantial capital expenditures for the installation of equipment to process Clean Fuels in Alaska. Of the total project cost estimate of over \$100 million, up to \$40 million may be spent in Alaska to build these improvements with \$20 million injected into the State economy in the form of wages and salaries. The Clean Fuels project could lead to as much as 100 to 200 direct jobs during construction with possibly twice that number of indirect jobs. To the extent that FHR's preferred strategy to produce Clean Fuels in Alaska will involve improvements at the North Pole refinery, construction employment will occur in the Fairbanks North Star Borough and the central Alaska region. Impacts on local and statewide employment and personal income from construction will be temporary. Incremental long-term employment and personal income effects generated by the Clean Fuels projects at North Pole of the refinery should be rather small.

Further, completion of the FHR refinery acquisition depends on a successful implementation of the proposed contract between FHR and the State. The proposed State RIK contract will help to ensure that transactions costs associated with the refinery sale are kept to a minimum. A delay of the sale of the North Pole refinery could result in deterioration of commercial arrangements with existing wholesale products buyers (e.g., airlines for jet fuel) and result in greater product imports into Alaska, with consequent job losses and higher in-state jet fuel intermediate prices and gasoline retail prices.

Finally, the business experience and qualifications of FHR as the new owner of North Pole refinery will ensure a seamless transition and ongoing success in operations at the North Pole Refinery.<sup>19</sup> FHR's core business is refining and its financial condition is well suited to support new investments at the North Pole refinery.

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<sup>17</sup> See Section III. A.1. DNR's forecast of the RIV alternative assumes that the destination value in the royalty settlement agreements will, over time, be revised through reopeners to achieve a value at or close to the ANS Spot Price. The \$0.30 per barrel premium used here is the difference between the RIV deduction for marine transportation costs and \$1.55.

<sup>18</sup> This range is based on multiplying the \$0.30 per barrel premium times the minimum 24,000 barrels per day and maximum 77,000 barrels per day quantity FHR may purchase under the proposed contract.

<sup>19</sup> The proposed contract gives FHR the right to assign the contract to a third party at a future date. The right of assignment qualifies the relevance of specific attributes and qualifications attached to a particular RIK purchaser, such as FHR.

**C. The projected benefits of refining or processing the oil or gas in the state:**

The North Pole refinery was expanded in 1998 and has a total capacity throughput of 227,500 barrels per day of ANS shipped to the refinery via TAPS. It consumes about 64,000 barrels of crude per day on average to manufacture petroleum products and, after removing the lighter components used to make petroleum products, returns the remaining 150,000 barrels per day of residual oil to TAPS. About 60 percent of refinery output is jet fuel. The remainder is evenly divided between gasoline/naphtha and diesel. These products are marketed to customers in Alaska, Western Canada and the Pacific Rim.

The refinery transported about 1.4 million gallons per day of jet fuel during 2003 and accounts for 56 percent of jet fuel consumption statewide, including military bases. Approximately half of the gasoline manufactured at the refinery is sold through Williams' branded retail stores throughout the state. Approximately 3,000 barrels per day of gasoline are shipped by rail to south central Alaska. FHR's commitment to process Clean Fuels in Alaska will mean that Alaska will not have to import low sulfur diesel and gasoline at potentially higher prices.

**D. The ability of the prospective buyer to provide refined products or by-products for distribution and sale in the state with price or supply benefits to the citizens of the State:**

Production capacity and processing equipment for the North Pole refinery is listed above in Table 2. The North Pole refinery has run successfully for 25 years and has seen several expansions. As buyer of the North Pole refinery, FHR brings considerable expertise and financial strength to Alaska. FHR is a wholly owned subsidiary of Koch Industries, a large, privately held company with interests in refining, chemicals, and fertilizer manufacturing. FHR operates a petrochemical refinery complex in Corpus Christi, Texas and another plant in Rosemount, Minnesota. It has controlling interests in Canadian oil sands development, as well as other Canadian crude oil marketing, trading, transportation and storage operations. In addition, FHR markets jet fuel, diesel, heating oil, gasoline, and other petroleum products.

The proposed contract requires that FHR use all commercially reasonable efforts to insure that royalty oil will be processed at the North Pole refinery. Furthermore, FHR is investing over \$265 million to purchase the North Pole refinery and has committed to implement construction projects that will likely total over \$100 million more, to allow for processing of Clean Fuels in Alaska. These financial commitments will bind FHR to a long-term presence in Alaska and ensure continued in-state refining to the benefit of Alaska citizens.

**E. The revenue needs and projected fiscal condition of the State:**

The State budget gap (the difference between unrestricted general fund revenues and general fund budget expenditures) is forecast to rise from \$275 million in FY 2004 to \$951 million in 2010, absent new revenue sources. Despite fairly stable oil production through 2010, the oil and gas sector's contribution to general fund revenue is expected to decline from 86% in 2004 to 77% in 2010 due to increasing production from new, lower-netback-value fields and a



higher economic limit factor (ELF).<sup>20</sup> The long-term cash proceeds from the sale of RIK gas and the premium over RIV will not fill this gap, but every positive contribution to State revenues is important to the State's fiscal balance, and the proposed contract would generate approximately \$2.6 to \$8.4 million per year in incremental revenue (over RIV) to help fill the State's fiscal gap.

**F. Present and projected local and regional needs for oil and gas products and by-products:**

Total annual fuel sales in Alaska by major product type are summarized in Table 3. The trend in annual fuel sales tends to be increasing for most products, except for modest downturns in 2000 (gasoline and No. 2 diesel) and in 2001 (jet fuel). Average annual jet fuel consumption increased 3.4 percent from 1997 to 2000, and then declined sharply before rebounding in 2002. The jet fuel decline in 2001 is probably related to the sharp nationwide decline in commercial aviation in the fourth quarter of 2001. Seasonal data (not reported) indicate that jet fuel consumption has recovered from the demand shocks of September 2001 and is consistent with average annual growth exhibited prior to 2001. Alaska's refineries supply nearly all of the in-state jet fuel consumed based on EIA data on prime supplier sales.<sup>21</sup> Total motor gasoline gas consumption exhibits a stationary pattern over the past six years. Annual average aviation gasoline consumption has increased slightly.

Year	Transportation Fuels				Total Fuel Sold	Non-Transport Fuel	
	Total <sup>a</sup> Gasoline	Aviation Gasoline	Jet Fuel <sup>b</sup>	No. 2 Diesel		No. 2 Heating Oil	No. 2 Distillate
1998	771.4	57.6	2,285.2	427.7	3,541.9	357.4	785.1
1999	784.4	58.7	2,434.4	467.2	3,744.7	295.9	W
2000	744.8	58.7	2,502.9	396.5	3,702.9	287.6	684.1
2001	761.3	61.2	2,461.9	462.5	3,746.9	227.4	689.8
2002	755.2	55.3	2,777.1	512.8	4,100.4	W	639.3

1. Jet Fuel Consumption and Airport Operations

Alaska's three refineries supply all of the jet fuel consumed at the international airports in Anchorage and Fairbanks, and at military bases in the state.<sup>22</sup> The international airport

<sup>20</sup> Alaska Department of Revenue, *Fall 2003 Revenue Sources Book*, Table 2-8, p. 18.

<sup>21</sup> Prime suppliers include firms that produce, import, or transport petroleum products across state boundaries and local marketing areas, and sell the products to local distributors, local retailers, or end users. According to the EIA, prime supplier sales within a given state may serve as a proxy for consumption but may not equal actual consumption by the end-users in the state because a product may be sold by a prime supplier in one state and transported by local distributors to another state for final consumption. Southeast Alaska communities import jet fuel and other products from the Lower 48.

<sup>22</sup> Jet fuel is generally not imported into Alaska unless unusual circumstances arise, such as the West Coast longshoremen strike of mid 2002, which resulted in greater-than-usual air cargo activity.

complexes in Anchorage and Fairbanks play a significant role in the state's economy. The Ted Stevens Anchorage International Airport alone employs 9,100 workers with a \$367 million annual payroll.<sup>23</sup> During the 1990s air cargo landings grew at an average annual rate of 9 percent, consistent with doubling in eight years.

Total statewide jet fuel consumption, driven largely by the strong growth at Ted Stevens Anchorage International Airport, increased from 2.3 million gallons per day in 1998 to 2.8 million gallons per day in 2002, an average annual rate of 4 percent per year.

## 2. Supply and Demand for Gasoline

The North Pole refinery and the Tesoro refinery in Nikiski are the only Alaska refineries that produce gasoline, with combined total production capacity of 22,000 barrels per day.<sup>24</sup> Gasoline production from these two refineries exceeds total in-state demand of about 16,000 barrels per day. The excess production (about 6,000 barrels per day, produced by Tesoro) is exported to the U.S. West Coast and to foreign consumers.

Approximately 300 retail outlets sell motor gasoline currently in Alaska. Williams' and Tesoro branded service stations account for about half of this total.

### **H. The desirability of localized capital investment, increased payroll, secondary development and other possible effects of the sale:**

The proposed contract includes several special commitments that could involve investment spending and improved refinery operations. These are outlined above and include the Clean Fuels project, a promise to examine feasibility to upgrade the Fairbanks International Airport hydrant fueling system, and potential tank farm improvements at the Port of Anchorage. In addition, FHR's substantial investment in purchasing the North Pole refinery, and its commitment to additional capital investment in the State, provide a more secure, long-term prospect for continued refinery payroll in the North Pole and Fairbanks region.

### **I. The projected social impacts of the transaction:**

The sale by itself will have no incremental social impacts. If there were no RIK contract executed to supply crude oil to the refinery, however, operations at the refinery might be suspended or cut back with possibly serious social consequences caused by worker lay-offs and fuel product supply disruptions.

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<sup>23</sup> Equals onsite annual average employment and payroll at Ted Stevens International Airport in 2000. These figures do not include "offsite jobs generated by airport business purchases and workers spending their earnings within the community." (Scott Goldsmith, "Ted Stevens Anchorage International Airport: Economic Significance 2000," Institute of Social and Economic Research, July 2001.

<sup>24</sup> The PetroStar refineries in Fairbanks and Valdez produce only jet fuel and diesel.

**J. The projected additional costs and responsibilities that could be imposed upon the State and affected political subdivisions by development related to the transaction:**

The proposed contract is expected to generate negligible additional public-sector costs and responsibilities. The proposed contract could result in improvements in the utilization of existing capacity but the growth of new basic-sector jobs over the long run is expected to be small. Refinery direct employment of approximately 150 full time equivalent, high-wage positions is expected to remain the same. Indirect and induced employment effects, induced population expansion are not expected to vary from recent patterns as a result of the transaction. Industry-related property tax revenues should rise as a consequence of the Clean Fuels investments at the refinery. Construction jobs related to the Clean Fuels project are expected to be temporary.

According to a recent Commonwealth North study by the Institute of Social and Economic Research, each new basic-sector job creates a \$1,100 annual burden on public finances.<sup>25</sup> This transaction is not expected to generate many new long-term basic sector jobs and should therefore not significantly increase public-sector costs. As indicated above, the potential unrestricted general fund revenues from this transaction are expected to be positive \$2.6 to \$8.4 million per year.

**K. The existence of specific local or regional labor or consumption markets or both which should be met by the transaction:**

The Williams refinery at North Pole employs approximately 150 full time positions, representing about 1/3 of total direct oil and gas employment for the five largest petroleum-related companies in the greater Fairbanks area.<sup>26</sup> The annual payroll associated with these refinery jobs ranges between \$8 to \$12 million. The refinery generates additional “indirect” jobs and payroll through vendors that provide goods and services to the refinery, as well as “induced” jobs through local spending of direct and indirect payroll. The refinery and its employees generate between \$3 and \$4 million per year in property tax revenues to the Fairbanks Northstar Borough.

The proposed contract is expected to have a small impact on long-term, direct refinery employment, other than by providing more assurance of continued operation of a refinery in the Fairbanks region. The proposed contract could increase property tax revenues if the Clean Fuels project adds \$100 million investment to the tax base for the North Pole refinery.

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<sup>25</sup> See <http://www.iser.uaa.alaska.edu/Products/2StrategiesforGrowth.ppt>.

<sup>26</sup> The companies are: Alyeska Pipeline Service Company, ConocoPhillips (formerly ARCO), BP Exploration, PetroStar, and Williams Alaska Petroleum. See Information Insights, “Economic Impact of the Petroleum Industry on the Fairbanks North Star Borough,” December 1999.

**L. The projected positive and negative environmental effects related to the transaction:**

There are positive environmental provisions included in the special commitments contained in the FHR's proposed contract.<sup>27</sup> The Clean Fuels project will provide potentially lower priced, low sulfur diesel and gasoline instead of importing such fuels into Alaska. FHR will also continue and complete the Anchorage tank farm improvements which include evaluation of facilities to determine compliance with State and Federal requirements including overfill protection, fire protection, tank seal monitoring, potential for change of product service, and possible removal of additional tanks, and prompt remediation of any violations of these requirements.

**M. The projected effects of the proposed transaction upon existing private commercial enterprise and patterns of investments:**

Flint Hills Resources agrees to the following special commitments that ensure continuation and and/or enhancement of existing commercial relationships involving the North Pole refinery.

1. Shipment by Rail

Williams currently ships refined products by rail under an agreement with Alaska Railroad Corporation (an Agreement originally entered by MAPCO Alaska Petroleum Inc. in May of 1993). As part of Buyer's refinery acquisition from Williams, FHR will assume the rights and obligations of Williams under the rail agreement and continue to ship refined products to Anchorage.

2. Air Traffic Marketing and Structural Improvement Study

FHR and the State will jointly explore commercially reasonable options for increasing passenger and cargo air traffic through the Fairbanks International Airport. FHR will work with the Fairbanks International Airport to concentrate on promoting the Fairbanks International Airport to cargo carriers operating between Asia and Europe and otherwise and will evaluate, and possibly upgrade, the airport's fuel distribution facilities, including the feasibility of using or upgrading the hydrant fueling system.

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<sup>27</sup> FHR has past issues regarding environmental compliance, including \$10 million in fines in 2001 for criminal violations regarding a cover-up of improper benzene emissions at its Corpus Christi refinery and over \$300 million in payments to settle lawsuits regarding pipeline spills in Texas. FHR spokesmen have indicated to the press that the company "has worked hard to improve its environmental record." Anchorage Daily News, November 18, 2003.

## **V. Findings and Determination**

### **A. Disposal of the Royalty Oil In-kind is in the State's Best Interest**

In accordance with AS 38.05.182, the Commissioner determines that it is in the best interest of the State to take its royalty oil in-kind to provide necessary crude oil supplies to the North Pole refinery.

### **B. Competitive Bidding is Waived**

The Commissioner determines, in accordance with AS 38.05.183(a) and 11 AAC 03.030, that the best interest of the State will be served by sale of its royalty oil in-kind to FHR under non-competitive procedures to relieve market conditions. The proposed contract will promote the interest of the State through increased revenues and by facilitating uninterrupted operation of the North Pole refinery.

In deciding to sell RIK to FHR under the proposed contract the commissioner considered that without the contract the State will receive less revenue because its royalty oil would be taken in-value without the potential \$0.30 per barrel price premium. FHR is uniquely qualified and positioned to assume ownership of the North Pole refinery and has agreed to provide significant additional benefits to Alaska through the Special Commitments of the proposed contract.

A copy of this Finding and Determination is being delivered to the Royalty Board as notification under 11 AAC 03.040 that the commissioner has determined that the best interest of the State does not require competitive bidding in this circumstance.

### **C. The RIK Oil Sale Will Relieve Market Conditions**

A non-competitive sale of royalty oil is permitted where necessary to relieve market conditions. DNR regulations, at 11 AAC 03.024, provide that a non-competitive sale of RIK oil may be held to relieve "market conditions" when one of four alternative conditions is met. The proposed FHR contract meets two of the alternative conditions:

(1) in a noncompetitive disposition of royalty oil, gas, or associated substances the commissioner estimates that the sale price throughout the term of the disposition will be higher than the volume-weighted average of the current reported netback prices filed by the lessees for royalty purposes for those filing periods applicable to the term of the disposition; and...

(3) the royalty oil, gas, or associated substances disposed of will be used to meet in-state needs for crude oil, gas, or associated substances or petroleum products and the sale price of that royalty oil, gas, or associated substances is at least equal to the in-value amount which would have been received by the state during the same period.

The proposed contract will relieve market conditions because it will provide needed crude oil supplies to the North Pole refinery and the price for oil delivered throughout the term of the contract will provide a potential premium of \$0.30 per barrel over the volume-weighted average of the netback prices reported by the North Slope lessees.

**D. The Proposed RIK Oil Sale Offers Maximum Benefits to the State**

When RIK oil is to be sold through a process other than by competitive bid, the commissioner must award the disposal to the prospective buyer whose proposal offers the maximum benefits to the State. In making the award the commissioner must consider the criteria set out in AS 38.05.183(e) and in AS 38.06.070(a). The commissioner's in-depth review and consideration of all of the required statutory criteria is set out above in Section IV of this Best Interest Finding and Determination. The commissioner finds that the proposed sale of ANS royalty oil to FHR, under the terms and conditions of the attached proposed contract, offers the maximum benefit to the State.

**E. Alaska Royalty Oil and Gas Development Board**

This finding and determination and a copy of the proposed contract is being submitted to the Royalty Board in compliance with AS 38.05.183(c) and 11 AAC 03.024 and 11 AAC 03.040, which require the commissioner to give written notice to the Board of intent to waive competitive bidding of an RIK sale.

**F. Legislative Approval**

Legislative approval is required for RIK oil dispositions with a term of more than one year. (AS 38.05.183). Legislation approving the sale has been prepared and is intended to be introduced immediately following receipt of written recommendations from the Alaska Royalty Oil and Gas Development Board.

**VI. Conclusion**

On careful consideration of the circumstances of the proposed sale, material information and legal requirements, the commissioner determines, in accordance with AS 38.05.183, that the best interest of the State does not require this RIK oil sale to be made by competitive bid, and that the proposed contract with FHR offers maximum benefits to its citizens.

<Signed>

2/12/04

\_\_\_\_\_  
Thomas E. Irwin  
Commissioner

\_\_\_\_\_  
Date

**Appendix A**  
**Proposed Contract**