Stranded Gas Hearings
(0409011615 Minutes)

Sales of State Royalty – The Alaska Experience
Kevin Banks, Petroleum Market Analyst, Dept. of Natural Resources, September 1, 2004.

KEVIN BANKS, Commercial Section, Central Office, Division of Oil & Gas, Department of Natural Resources (DNR), relayed that his [PowerPoint] presentation would touch on the development and status of Alaska's current royalty in-kind (RIK) program, on a couple of royalty contracts that the state has recently entered into, and on a possible future direction that the state might choose to go in. He explained that royalty is a share of production: the ownership of the oil or gas that the state keeps in a contractual arrangement with its lessees. The state can choose to take royalty in-value (RIV) or in-kind; when taken in-value, the mechanism used to calculate the value is subject to a "higher of" calculation. That [was] the case for Alaska North Slope (ANS) gas, although through various royalty settlement agreements and arrangements with respect to oil, that has changed.

MR. BANKS went on to say:

> We can look to how the producers, or the lessees, are selling oil and gas, compare that to what the market is, how others in the same field are doing, and [then] we're entitled, under the provisions of our lease, to get the highest of those values. The lease also requires that the producers/lessees assume the responsibility of [marketing] our oil and gas along with their own ... share. And I think that's an important feature to make [note of], because if we take gas or oil in-kind, ... then it's our responsibility to market our royalty share.
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> Why take RIK? ... The commissioner ... may only award a contract if it serves the maximum benefit of all citizens. And even in the enabling legislation for the Alaska Royalty Oil and Gas Development Advisory Board, which we call the Royalty Board, ... [it states] that the decision to take royalty in-kind or in-value falls on whether or not it promotes and facilitates wise development of our resources and provides for economic growth and other kinds of benefits ... within the state.
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> That's an important feature. ... The state develops this right ... by the arrangements we have with the lessees in a lease agreement. ... We offer leases for sale in a closed-bid auction; the lessees agree that we may take our royalty in-kind or in-value at our election, [and] ... the only provision that encumbers that right is that we have to give them appropriate notice. Under the old leases that are on the North Slope, that used to be six months' notice. The newer leases are three months, and, as far as oil is concerned on leases ... in Prudhoe Bay, it's been changed to three months as well.

MR. BANKS continued:

> So we get a little [bit] of flexibility. As long as we tell the producers, with appropriate notice, that we want to take our oil in-kind or switch it back to in-value, that's something that they have to do. ... The rules [that] apply to oil and gas, under the lease, are the same, although, as I've said, various agreements have been entered into over the years with the producers that have changed the nomination procedures for oil. And this has been part of our leasing program for [40] years - all of the leases have a [similar] condition ..., you see it in leases in the Lower 48 as well.
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> Importantly, it gives us the right to switch from royalty in-kind [to] in-value, and we regard that as having value in and of itself. ... If we think that what we're getting for in-value is too low, for example, and we think we can do better if we take it in-kind, ... we can take it in-kind - and sell oil and gas - and improve our position. If we think that keeping it in-value is a better deal, ... we can switch it back to in-value. So that by itself imparts a certain value to the state in terms of revenues for its royalties. ...
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> Switching on and off, or raising or lowering the amount of royalty in-kind, is important to us because that gives us the opportunity to sell to customers that the producers might not be willing

to sell to - in-state refineries is a good [example] - and we can also offer terms that are different than what would be more normal contracting arrangements. And I'll give you two examples ... in a moment, but even about 12 years ago we entered a 10-year contract to sell oil to Petro Star [Inc.] to supply their refinery in Valdez.

They never took any oil under that contract, but just the possession of our contract and the assurance of a supply of oil for a period of 10 years was sufficient to get the financial backing they required to get the refinery paid for and constructed. And similarly we offered [Flint Hills Resources, L.P.] a long-term contract, which you don't normally see in the marketplace, so that they too could finance ... the purchase of the refinery. Of course, I believe the state was able to get a premium for that kind of arrangement, and also now we have a viable and what I think will be a fairly good customer in [Flint Hills Resources, L.P.] at the North Pole refinery.

MR. BANKS, referring to his presentation, said:

Just to give you an idea of what our switching has been like in the past, this chart shows that at times we've taken almost all of our royalty in-kind. The green area represents basically the total amount of oil that's produced on the North Slope ... since 1979 through 2002, and, as you can see, we've kind of jumped up and down over time in taking royalty in-kind. We've offered it in competitive sales, most often we've sold it to local refineries, and the situation now, if you were to forecast that out, will look a bit as it has been in the recent past, where a little over half of our royalty will be sold to [Flint Hills Resources, L.P.].

Now, there was a question earlier about whether or not RIK and RIV are equal, and [whether] the price we receive for our royalty should be the same. I think it's a principle that's stated in somewhat elliptical ways in our regulations and our statute that that should be a requirement, that when we decide to sell royalty in-kind, that we should at least get as much for it as we would have in-value. Arguably, ... we might even look to court decisions that would have said the same thing.

MR. BANKS, referring to different pages of his presentation, said:

This chart gives you an indication of how well we have done. We sometimes miss, we sometimes do better. ... [This graph] says about the same thing, except in terms of differentials, that on balance, in the last 25 years of a royalty in-kind program on the North Slope, we've just about broken even. And that's in spite of the fact that there were times when we had contracts that had distinct [premiums] associated with them. There have been other times when we've just missed it, most notably when we sold oil to [Alaska Petrochemical Company (Alpetco)] in Valdez and the company went belly up and couldn't pay for the oil that we had nominated and dedicated to them, and [we] ended up having to resell it back into the market and ... to the producers at a loss.

Now I'll get to the recent contracts. .. As you know, we brought to you last session the [Flint Hills Resources, L.P.] oil contract, and, a couple of years ago, the department negotiated a contract with Anadarko Petroleum Corporation and EnCana Corporation - EnCana used to be [Alberta Energy Company Ldt., AEC] before [it] was purchased by EnCana - and I'll touch a little bit on the terms of those agreements. All of our contracts have similar terms, and of particular importance are the four I've listed here for [Flint Hills Resources, L.P.]: price, special commitments, the kind of quantity that we're going to supply, and for a certain length of time - [term].

MR. BANKS relayed:

Flint Hills's price is not what [we] have normally charged "royalty in-kind" kinds of customers for oil. The norm had been, since the very beginning on the North Slope when we first started selling oil to [MAPCO Alaska Petroleum Incorporated] in 1979, that the price would be based on what we would have received for the royalty in-value. ... It specifies, "You pay us the in-value price." In the Flint Hills contract, I think owing to the fact that we have a much better understanding of oil markets now for North Slope crude then we could ever have had in 1979, we modeled the pricing term for Flint Hills in a way that mirrors the same calculation that we make for our in-value oil, which, in turn, mirrors the calculation that the lessees themselves use when they sell oil.

So we have a market standard, so to speak, in the way oil contracts are priced, and the Flint Hills contract is priced off of an ANS spot price, so it's an index price - it will follow the market - and we

believe that the term and the calculation that we've developed in this contract will yield a premium for our oil in-kind [versus] ... having kept it in-value. Flint Hills also promised to give us special commitments, and these are ..., I think, very important but are [of a] non-monetary value to the state.

In the Flint Hills contract, that included upgrades to the refinery for it to make clean fuels, ... voluntarily hiring Alaskans where they could, taking reasonable efforts to use all of the royalty oil that they buy for us to make products here in Alaska and to supply the jet fuel and consumer gasoline market, ... [promising] to abide by the commitments that Williams [Companies] had made ... as they [proceeded] to upgrade the tank farm in Anchorage, ... [promising] to ship [oil] ... and other products on the railroad, and ... [promising] to promote development of the international airport in Fairbanks and ... provide gasoline in Fairbanks and Anchorage at parity.

MR. BANKS remarked:

And while those are non-monetary kinds of values to the state, it's something that we were able to negotiate with them. In return for the price and those kinds of special commitments, Flint Hills receives from us assurances of a quantity of oil that basically meets their requirements and with sufficient flexibility to adjust for seasonality, and we've also committed to supply them oil for 10 years. And so under those circumstances, I think we struck a fairly good deal for the state with Flint Hills.

SENATOR THERRIAULT asked for more information about the MAPCO contract.

MR. BANKS said that there were two contracts with MAPCO. The original 1979 contract had a "schedule B" pricing mechanism, which was intended to capture an amount that matched what was anticipated would be received via the ANS royalty litigation. He noted that as a result of this mechanism, there was a fairly close match with RIV but not with RIK. A second contract with Williams [Companies] - the successor to MAPCO - was signed in 1998 that agreed to RIV plus $.15, and this outright premium had no restrictions with regard to retroactive calculations.

MR. BANKS, on the issue of the Anadarko Petroleum Corporation and EnCana Corporation contract, said that after negotiating the agreement, the department submitted, for review by the public, a preliminary best interest finding on March 29, 2002. No further action has been taken on the agreement, however. The two companies had had concerns about how they could nominate for firm transportation commitments in a pipeline when they didn't have any gas to nominate - they hadn't gone out and begun to explore for it; furthermore, how could they go out and explore for it if they didn't have the means to transport their gas off the North Slope. The department saw an opportunity to go about making arrangements to help them out for a price. The response from Anadarko Petroleum Corporation and EnCana Corporation involved a proposed contract that included a price equal to RIV plus a premium, and a cash option price to exercise a renewal on the contracts every five years for as long as it took to get the pipeline built, get their gas into the pipeline, and back out the state's RIK gas.

MR. BANKS said that the advantage of this type of contract is that it would give Anadarko Petroleum Corporation and EnCana Corporation the opportunity to take the state's gas and fill their pipeline space with it while they proceeded to develop their own gas supplies; then, upon discovery and development of their own gas, they would have the option to take the state's gas off the pipeline and replace it with their gas. At that point, the state could simply switch back to RIV and benefit from having two more gas producers on the North Slope with access to markets for selling gas.

MR. BANKS, in response to questions, said that there are FERC regulations in place that are designed to offer open access through an open season process, though there are some shortcomings, since those regulations are designed to work in situations where there are more competitive opportunities to move gas from a particular place. Additionally, there are provisions in the federal energy bill that may improve access opportunities for folks like Anadarko Petroleum Corporation and EnCana Corporation. He reiterated his comments regarding aspects of Anadarko and EnCana's proposed contract.

MR. BANKS, in response to another question, said that the point the state would deliver gas to Anadarko

and EnCana would be the same place, as yet undefined, where the state would receive its royalty if it were taken in-value, and it is as yet unknown whether the state would take gas as royalty before it moves through the treatment plant or whether it would take it after. Anadarko and EnCana could then acquire firm transportation capacity for the state's royalty gas and send it all the way to the marketplace, wherever that ends up being. The proposed contract also anticipated that there might be some offtake of a small volume of gas that Anadarko and EnCana would be willing to sell back to Alaskan communities if necessary. "It's a kind of a 'take or pay' capacity agreement, you see; they would commit to move 350 million cubic feet of gas down this pipeline [and] if they didn't have it, they'd still have to pay for it," he explained.

MR. BANKS said it is not an automatic decision that expansion of the pipeline would occur simply because there are customers available and looking for it to happen. The FERC cannot require such an expansion, and so normally Anadarko and EnCana would have to go to the producers and ask for expansion to take their new gas; thus the decision would be left up to the producers to a certain extent - they would have to find that it would be economically viable to take that gas. Under the proposed contract, however, it would be the producers that would have to take the royalty gas back in-value and find space for it, either by expansion or by backing out their "working interest" gas. He added, "We tried to accommodate for that eventuality in the contract by changing the nomination schedule that is currently embedded in the contracts."

MR. BANKS said that under the proposed contract, Anadarko and EnCana would be required to give the state a much longer lead time to change the percentage of royalty gas that they were taking, and if their own gas were to be put into the pipeline in place of the state's gas, the state would get a two-year nomination notice period. This would give the producers sufficient time to make adjustments, to either plan for an expansion or otherwise accommodate the switch back to RIV. The proposed contract with Anadarko and EnCana contained commitments similar to those in the Flint Hills contract, including an exploration program of $50 million a year, instate preference for contracting and local hire, and a $25,000-a-year training program, which would last 10 years and train Alaskans [in the industry].

MR. BANKS, on the issue of future RIK challenges and opportunities, said:

> I've made two points about royalty in-kind that I think are important. The fact that we take royalty in-kind and have historically taken it at the point where it's delivered to us as in-value, is a rather important issue. With respect to oil, it's fairly easy for us to do that because the [Trans-Alaska Pipeline System (TAPS)] ... is a common carrier. Our customers have the same access to the TAPS ... as anyone else, and so they can step up and buy our oil in Prudhoe Bay or at the inlet of a pipeline and pretty much be guaranteed the opportunity to deliver it to their refinery down the pipeline. ... As the Anadarko and EnCana contract illustrates, that's not the case for gas, where, if we were to take our gas at a delivery point upstream of the pipeline - either at the inlet of the gas treatment plant, or at the outlet of the gas treatment plant but ahead of the pipeline - our customers are going to have to find a way of moving it, [of] taking the gas away to market.
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> The second issue that I think is important is that in the pricing mechanism for oil, we're now able to sell to Flint Hills mirroring what we appreciate is going on in the marketplace. The mechanism of relying on an ANS spot price, for example, is a very good indicator of what the market of ANS oil is, and so it's easy for us to point to that and say, "Here's how we'll index the price of our royalty oil.'" Gas is not there yet ... because we're not there yet; we haven't begun delivering gas to Alberta or Chicago or wherever it may go, and haven't yet established the kinds of market indicators that we might want to apply to a royalty in-kind contract. ...

MR. BANKS continued:

> [So] where we take the gas and how we price it will become fairly important. If we take gas at the inlet of the pipeline, our customers will have to assume the risks of taking a firm transportation commitment on the pipeline, and the risk that when they sell gas ... in the marketplace, they'll get enough to pay for the transportation charges. The state could, as an option, assume that risk by delivering ... our royalty gas at the "ACO" (ph) hub in Alberta and assume the transportation risk ourselves and, presumably, we would then be able to charge our customers accordingly.

> So now, as we move forward, we're going to be facing questions about how much risk the state is willing to take when it sells its gas, ... are we a "price taker" as we have been in the oil business for 25 years, or would we be willing to step out into the marketplace. If we do [the latter], what kind of marketing organization do we think ... we would like to develop. ... [Also, we should recognize] that people and expertise and the functions of a marketing organization all come with a cost. ... I think those are the questions [reflecting] where we are right now, trying to deal with those kinds of issues. If you have any more questions, I'd be happy to take them at this time.

SENATOR LINCOLN noted that there were only three months between the time the final finding and solicitation for offers was published and the time the contract negotiation with Anadarko and EnCana was completed, and said this seems like a very short timeframe. She asked whether such a short timeframe is normal for DNR.

MR. BANKS said that the timeframe has historically been governed by the motivation of the customers, and the state takes a passive position with regard to selling royalty. And while the state will nominate oil when it can and sell it to someone, the terms of an agreement are designed to strike a balance of risk that favors the state, for example, by avoiding default risk. He characterized the aforementioned three months as incredibly long in terms of how producers and gas suppliers and oil suppliers behave in a regular market, where deals are done in a matter of hours depending on the quantity and the term of the agreement. For example, it might take three to four weeks, at the outside, to establish a one- or two-year contract between a producer such as ConocoPhillips Alaska, Inc., and a customer for oil in California. Those [producers] know their customers, they're in the business of selling, and, hence, they're much more nimble in the marketplace.

SENATOR LINCOLN asked whether the aforementioned commitments with Flint Hills and Anadarko and EnCana regarding Alaska hire and utilizing Alaska businesses are "set in stone" or involve certain percentages.

MR. BANKS replied:

> In the agreements that we've had and that I'm familiar with, going back to ... 1990, ... [they] all have some language with respect to local hire. And ... at this point, I think, the state, in its role as a government, can run afoul of constitutional problems in enforcing some kind of very specific local hire rule. I suppose [in] a deal between BP and ... Flint Hills, they could say anything they want about who to hire, but we can't. And so the agreements have always stressed, "To the maximum extent possible," or "As available," and "At times, ... [you] voluntarily will hire Alaskans." ...

SENATOR LINCOLN asked whether the local hire commitment is monitored by the department.

MR. BANKS said it is to a certain extent.

SENATOR THERRIAULT asked why no further action has been taken on the Anadarko and EnCana contract.

MR. BANKS indicated that that decision was made during the previous administration and probably involved a variety of factors, adding that it was not an uncontroversial issue. "In the request for comments that accompanied the RFP, the producers all objected to the RIK sale," he noted, and so the attendant controversy prompted the parties involved to wait. In response to another question, he explained that the current contract, which is as yet unsigned by either party, contains some provisions regarding timeframes within which the parties could withdraw.