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JOINT RESOURCES PRESENTATIONS

BY SPENCER HOSIE and MARK COTHAN

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TRANSCRIPTION SUPPORT SERVICES

4782 Mills Drive
Anchorage, Alaska 99508
907/333-6256
907/337-0243 (fax)
e-mail: lsfoley@acsalaska.net

you, Mr. Chairman.

CHAIRMAN: Okay. Further questions? Seeing none, thank you, Mr. Hosie. We will move on to our next presenter.

MR. HOSIE: Thank you, Mr. Chairman, members of the Committee.

CHAIRMAN: We have next a group with Cothan, Harwell and Evans, counsel to the Alaska Gas Port Authority.

UNIDENTIFIED MALE SPEAKER: Mr. Chairman, members of the Committee, thank you very much for the invitation to offer a second opinion on gas development issues. Because Alaska doesn't have a myriad of royalty owners that other states do, a lot of this comes from out of state issues and we were in for the firm of Cothan, Harwell and Evans, a firm with over 70 years in combined experience resolving commercial oil and gas issues. With me are Mark Cothan and Mark Harwell. Their firm continues to focus on issues such as failure to develop and other producer royalty claims. Mark Cothan will be making the presentation.

MR. COTHAN: Thank you very much. I think today we are somewhat witnessing history insofar as I believe you're going to see two lawyers representing two different parties almost entirely agree on what the law is and that's a rarity. The law as Mr. Hosie put it -- put forth, I think, is really not controversial. I think that if you would look at the treatises, look at the case law, etcetera, you will not find that there is truly a difference as amongst the various producing jurisdictions. In fact, there is a consensus as far as the law here that is very, very uncommon both in oil and gas law and the law generally. We've been asked by the Port Authority to review with you the legal duties and obligations that the producers have with respect to the Alaska North Slope gas. Obviously, my testimony is based on case law and my 23 years experience as a lawyer in this field and is not intended to reflect any particular statement of position by the Port Authority itself.

In finding my testimony and trying to be as informative as possible, I -- I've looked at some of the discourse that was associated with the general debates that are going on. It's between the producers and it's between just whether or not a pipeline will, in fact, be built and one of the things that struck me as strangely missing was any discussion about what are the producer's obligations in these circumstances. There's been a lot of talk, of course, about the importance of the federal loan guarantee and how that might play a role in getting the pipeline built. Likewise, the producers have been quite forthcoming in terms of insisting that there be royalty concessions and tax concessions and who knows what other concessions they may or may not be asking for but, to my knowledge so far until Mr. Hosie spoke on this subject, there has not been any true significant review with respect to the duties that a producer has. To try and clear up the air and to try and analyze for you the legal duties that we see here, I plan to address five what I would regard as misconceptions that exist in this area.

Five misconceptions that we have, first, is that the oil companies own the Alaska North Slope gas; second, that the oil companies have complete legal control over if and when that gas is produced and marketed; third, the oil companies can choose how much profit they want and delay developing or marketing the North Slope gas until their profit goals through state concessions or otherwise are met; fourth, the oil companies, by owning the leases, have the legal right to dictate the location, ownership and structure of the pipeline; and then, finally, fifth, that the state is somehow in a weak position to negotiate with these oil companies.

Let me go through each of those what I consider to be misconceptions and explain to you what I believe the law is and how it is established. Starting with misconception number one, I believe that the reality is that the producer's leases, just as Mr. Hosie indicated, give them the right to develop and market the gas however they have corresponding responsibilities and if, in fact, those corresponding responsibilities are not met, it is my position that under the clear terms of the lease, those leases can be absolutely canceled such that the State of Alaska becomes the owner of that gas if the oil companies refuse to adhere to their divvies.

There was a question by former Chairman Ogan last fall that I kind of liked. It's -- the question was how does one get past the reality that the guys with the gas make the rules and while I sympathize with what he was getting at, the point is these oil companies do not own this gas. As a matter of property law, as a matter of any type of underlying oil and gas law, they are not the owners of this gas. As Mr. Hosie so eloquently put it, what is conveyed by an oil and gas lease is, first, an exclusive right to explore and produce. That is how these oil companies have, for instance, produced almost 14 billion barrels of oil from Prudhoe Bay. On the other hand, what the oil companies give back is, in the first instance, a bonus which is determined by competitive bid; also a royalty which, of course, is, in this instance, roughly 12-1/2 percent but, finally and importantly, they give back a commitment to develop, produce and market that gas.

I think when we talk about the ownership rights and responsibilities, I think it may be helpful to try and draw an analogy that, hopefully, we can all take advantage of. Let's contrast for a moment the difference between just a single individual owning a hamburger stand and a McDonald's franchise and then we'll talk about how the oil companies' rights relate to that circumstance. If we look at the single owners, obviously, he owns -- he or she owns one hundred percent of the hamburger stand. They also can run that hamburger stand however they want to and if they run it well or if they run it poorly, it remains theirs under any circumstance unless somehow the law takes it away.

Let's contrast that now with the McDonald's franchise. While a McDonald's franchise owner has a lot of the incidents of ownership, in fact, he is subject -- he or she is subject to a franchise agreement and that franchise agreement makes various conditions which must be met in order to retain the franchise. You have to have certain hours, you have to meet certain quality standards. All those sorts of things are normally in franchise agreements. Finally and importantly, if that McDonald's franchise fails to meet its obligations under the franchise agreement, it is subject to losing that franchise. Now, let's contrast that just for a moment with the oil and gas lease situation that we have here.

Again, if we were just talking about an owner of the minerals, we'd have the same basic incidents. They would hold one hundred percent of the title, they could run the lease however they wanted to and no matter what, they would remain the owner of that property. The producers have no such rights. The producers have a specific contractual duty which is spelled out in their leases. They must diligently develop and produce the gas. They don't have the right that a normal owner would to develop or not. They have to develop as a matter of law. Likewise, they must, as a matter of law -- as Mr. Hosie was discussing, they must diligently market that gas. Finally and importantly, the lease itself specifically provides that if they do not meet the terms of the lease, the lease is subject to being canceled. So when we talk about the ANS gas being owned by the oil and gas companies, I believe that, frankly, that is a fundamental misconception.

Understanding that they do not own this gas, the question becomes what do their rights entitle them to do in terms of the control? Can they control if and when the gas is self produced? Is it simply a one-way street? We believe, again, the law is unquestionably that it is a two-way street, that just as we've discussed already, there were rights but there are also responsibilities that come with those rights. Oil companies are subject to very specific duties to develop. The duty to develop this acreage is expressly set out in the lease and we'll talk about that language in a minute. Secondly, the duty to market gas with reasonable prudence and diligence is, as Mr. Hosie pointed out, something that every oil and gas jurisdiction agrees exists in elite.

Taking a look at -- this happens to be the modern form lease but I have compared it and gone back to the DL form that Mr. Hosie is talking -- was talking about. Looking at the language of the lease -- this is the contract, basically, between the producers and the state -- it indicates the lessee shall exercise reasonable diligence in drilling, producing and operating wells on the leased area. It goes on, the lessee must drill those wells as a reasonable and prudent operator would drill, having due regard for the interests of the state as well as the interest of the lessee. Now, again, if we go back to the DL form, it has, essentially, comparable language of the -- it's amazing, the language has not changed significantly over any period of time.

The second duty which we've already talked about, again, is reasonable diligence being required in marketing. As in the case of the covenants produced, the lessee is also under an implied obligation to market with due diligence the products that are produced. Obviously, without that benefit -- without that happening, the lessor receives no benefit.

I think it is important when we talk about diligence -- because we are talking about it as being something that is going to be required of the oil companies -- that we draw some distinctions. As far as the pipeline itself is concerned right now, we've, of course, seen inaction. We've seen inaction on the level that there's been no pipeline built and, indeed, there has been -- at least to date -- no acceptance of any offer to purchase that gas either. If we go within -- if we talk about what is required, I think it is really the blue circle and that is diligence. In other words, it is not absolutely incumbent upon the oil and gas companies to succeed if, in fact, success is not reasonably possible but it is incumbent upon them to be diligent. In other words, they cannot wait 35, 40 years in order to develop these assets. They have an obligation to be out diligently trying to market these -- this gas and, in fact, if we look next, there's an indication here that reasonable diligence in marketing requires, under the law set out in our paper, a very diligent effort to seek out pipelines and to market. Just to draw a distinction here as to what is due and what is not, the debate here need not be over whether or not the oil companies must build a pipeline. Let me tell you, the case law could not be clearer that the oil companies do not have a duty to build a pipeline. Under no circumstances could a court, in my opinion, require them to build a pipeline. What they must instead do -- and, again, the law could hardly be clearer -- is they must seek out in an aggressive way available markets. They must respond affirmatively if an offer such as the Port Authority's offer is reasonable and they cannot simply say no, we don't like that, we don't like anything. Again, I completely agree with Mr. Hosie's statement in that regard.

If, in fact, there is an existing pipeline, there's Texas case authority of the Texas Supreme Court, the *Cole Petroleum* case, which is cited in the written testimony. That was a case where for a two or three-year period, a producer refused to sell into an existing pipeline. That refusal, in turn, led the Texas Supreme Court, under the lease which is very, very similar to the lease we have here, to say that in and of itself was grounds for cancellation of the lease and, in fact, the Texas Supreme Court did that.

Now let's deal with misconception number three, the oil companies can choose how much profit that they want and delay developing or marketing the ANS gas until their profit goals through state concessions or otherwise are met. This gets into a lot of the issues that Mr. Hosie was talking about although I draw one distinction here. As I've indicated, the terms of the leases and the common law itself require that the oil companies develop and market the North Slope gas when they have a reasonable expectation of profit and it is my belief that that reasonable expectation of profit is unquestionably existent today and here is where I would draw a brief distinction between what Mr. Hosie was talking about and what I believe is the germane issue. We do not need in the context, for instance, of the Port Authority's offer or, frankly, any other offer to look very far to determine whether or not the oil companies have a reasonable expectation of profit. The basic equation that we would be talking about in that context is simply very, very small changes have to happen at the North Slope in order to instead of re-injecting the gas, process it and then send it down the line and particularly when you have a party such as the Port Authority that has offered to specifically build the treatment facility, to assume one hundred percent of the risk along with the federal government loan guarantee but, nonetheless, the oil company bears none of the risk of financing the pipeline. In that context, I do not believe that you can at all make -- with a straight face -- an argument that there is not a reasonable expectation of profit. Under the Port Authority's figures, for example, the oil companies under, frankly, fairly modest projections would stand to net a billion dollars a year of -- even if the projections turned out to be far less than, frankly, everyone suggests that they might be. They would still, nonetheless, be making an extraordinary profit, almost an infinite profit given that they don't have to expend anything in the circumstances that we're talking about.

I think it is really helpful -- and I thought Mr. Hosie got a great start on this issue -- to talk about what is going on with the producers and to contrast that with the legal obligations that we agree exist here. There are basically two different types of categories that were the subject of testimony before this Committee last fall in terms of how producers look at these projects and I think both of them bear significant scrutiny in light of where the development of the pipeline is today. The first category is whether or not a project is viewed as discretionary or non-discretionary. The second has to do with do you characterize is as non-economic, as economic or competitive?

Let's take it here as an illustration a typical oil company budget and, again, this was the subject of testimony by the former president of ARCO as well as the producers themselves last fall were telling you this is basically oil companies may look at things for budgeting purposes. They first have a category of non-discretionary items. Again, those were described last fall as being such items as mandatory health, safety and environmental investments, projects where they'll lose a concession. For instance, if a cutter tells them you have until X date and by X date, you're either in or you're out, that's viewed as nondiscretionary, assuming they want to go forward with the project. The balance of the projects that may make up an oil company budget fall into the category of what is discretionary. Here we have for Exxon or ConocoPhillips or BP an extraordinary list of different potential projects, one of which is doing something with the Alaska gas pipeline and/or simply doing something with the reserves themselves.

Why is it that we believe today you can no longer characterize the Alaska North Slope gas as a discretionary decision? The reason is, to begin with, this is not a case where we have any question about reserves. We have extraordinary reserves -- indeed, many, many millions of cubic feet of gas are actually being produced on a daily basis. Instead, they are simply being reinjected. Secondly, as mentioned, there is virtually no production expense that the oil companies would be asked to assume if they were to accept an offer such as the Port Authority's offer.

Finally, we have -- are blessed these days with a very strong market. Gas prices appear not only today but for every kind of projection, the supply and demand curves appear favorable to make the State of Alaska a substantial royalty if this gas can be sold. Those things combine to make more than a reasonable expectation of profit.

We now get to the issue that I think Mr. Hosie spoke well about and that is how do these oil companies rank potential projects? We, again -- and in the fall testimony, fall of last year, there was testimony that there was, basically, a distinction that was drawn between what are noncommercial projects, what are commercial projects but not competitive and then what are competitive projects. Again, just to illustrate the same point, we have -- out here on the fringe, we have things that don't make sense. You're just going to lose money doing them. No one here argues that an oil company has an obligation to go out to make the state (indiscernible - coughs) to lose money. We then have a category which is commercial. Those are things which would return the cost, the capital cost plus something and you can start out here on the fringe and talk about things that would just barely break even but make a little bit and then you can get further in and I agree a thousand percent with what Mr. Hosie said and that is as you get further in towards the commercial realm, you undoubtedly will find that there are oil and gas developments -- specifically, the North Slope -- where it is commercial under any circumstance and a reasonable profit can be made. Now, it is not the state's obligation to go out -- and, indeed, we cite legal authority for this proposition -- the state does not have to go out and compete with these other projects. Instead, the question is are these commercial such that a reasonably prudent operator would go forward with them and, again -- well, I think unquestionably, that situation exists today.

Moving to misconception number four, the oil companies by virtue of owning the ANS leases have the legal right to dictate the location and ownership of the pipeline. We do not believe that simply because they have some rights with respect to the North Slope gas, they basically can dictate who owns the pipeline, where it is to go. In fact, they have, as we've already spoken, a duty to prudently develop and market this gas independent of any other profit making opportunities that they may have. If they want to make money in Qatar, that is fine but, nonetheless, they have signed an agreement and under that agreement, as interpreted by every state in the union that has addressed the issue, they have a duty under these circumstances to market this gas. That is a duty that cannot be sacrificed for other profits the producers may decide. Under no circumstances could that occur.

I guess another place that I would draw somewhat of a distinction with what Mr. Hosie was talking about is, in our view, the antitrust implications of simply refusing to sell gas. We believe and, indeed, there was testimony in February -- a FERC expert that this Committee hired -- himself raised the issue of whether or not there were antitrust concerns with a simple refusal to sell any gas under any circumstances. We believe that, in fact, that could -- if the oil companies chose to simply refuse to sell the gas, that could be construed -- it's what is known as monopoly leveraging. Now, monopoly leveraging, according to the textbooks, is the leveraging, a monopolist use of power in one market to gain an advantage in a related market or power held in one time period to gain advantage in a later period. Often the leveraging occurs in a vertical context as when an upstream producer with monopoly power uses that power to gain advantage in a downstream market.

Now, the issue here is if the oil companies were to use their monopoly, their 90 to 95 percent leasehold interest in the North Slope -- if they are going to use that to basically exclude competition along the pipelines where no other pipelines can compete because of that ownership, we believe that that could be construed as monopoly leveraging which leads us to misconception number five, the last one.

We believe that it is fundamentally a misconception that the state is in a relatively weak negotiating position with these oil companies. The reality, we believe, is precisely the opposite for three fundamental reasons. Number one, we believe if the oil companies insist on not marketing these ga -- the gas, their leases can be canceled and Mr. Hosie is absolutely right that a traditional remedy is conditional cancellation. I believe based on the language that is here in the leases, that an unconditional cancellation would be perfectly within the state's right and the state could if it so chose unconditionally cancel that. It might require a judicial proceeding but that is a power that the lease specifically affords the state.

Secondarily, if the oil companies insist on not marketing Alaska stranded gas, the damages for this could be enormous. Thirdly, again, we believe that anti-competitive refusal to deal would be actionable under the antitrust laws and that these laws provide mandatory treble damages and injunctive relief.

Talking about lease cancellation, again, here we have one of the modern forms but the DL-1 form has fairly comparable language. The lease itself provides default and termination and cancellation. The failure of the lessee -- that would be the oil companies -- to abide by all express and implied provisions of this lease is a default whenever the lessee fails to comply with any of the provisions of this lease and fails within 60 days after written notice of that default to begin and diligently prosecute operations to remedy that default, this lease may be terminated by an appropriate judicial proceeding. Indeed, just to give you a little bit more flavorful language, what we have not put up here is if there is no well on the property, the Commissioner is given the power without even going to a judicial proceeding to cancel the lease.

There's no doubt in accordance with the case law, the cases that address this issue before that, in fact, the state could cancel the lease. One of the authorities, Professor Summers, one of the leading treatises on law and gas says if the lease contains an expressed provision for forfeiture of the lease for breach of all covenants thereof -- that's exactly what we just read -- which either by express terms or by construction of the court includes implied covenants and has the effect of making them conditions, there would seem to be no doubt that the lessor is entitled to declare a forfeiture for breach of the implied covenant to market and recover in an action to quiet title or cancel the lease. That is precisely the circumstance we believe exists if the oil companies refuse to reasonably market this gas. We've been through the lease provision before. It meets that. It's also, as I mentioned earlier, the *Cole Petroleum* case where the Texas Supreme Court addressed virtually identical circumstances, stands for the same proposition.

Strength number two that we believe that the state brings to bear in these negotiations or in developing the gas is the damages claims. In other words, if the oil and gas companies refuse to develop this gas, we believe that the state will incur extraordinary damages for which it would have a remedy in court. Perio -- again, it's one of the leading authorities, Professor Coontz's treatise on the law of oil and gas where he states damages are recoverable for breach of the implied duty to market the product. It has been held that damages may be recovered concurrently with the cancellation of the lease. The measure of damages for breach of the implied duty to market the product is the royalty which the lessor would have received if the product had been marketed. Now, particularly -- I think this damages issue really does emphasize, to my way of thinking, the importance of something being done sooner rather than later. In other words, if a proposal such as the Port Authority can begin the flow of gas, could begin that gas being sold, royalty being generated, it would not have the damages, the damages would not accrue. On the other hand, if the oil companies for whatever reason -- if they attempt to put together a proposal and are stymied for several years by antitrust considerations, if they attempt to put a proposal together and they run into a five -- between competing five primes and Canada, say, if all of those things combine together, the state will have been banished simply because the oil companies wanted to do it a different and, in fact, not equal and not, we believe, the prudent way and will have damaged the state by virtue of having delayed that production. Now, when we talk about delayed production, obviously, time is money but to me, it is more than simply putting off for a little bit the receipt of royalty. I like to think of royalty in this context, as every dollar of royalty or every day for which royalty is not paid, that royalty effectively goes to the very end of the line. In other words, if you missed a year of royalty and then a pipeline starts up, you don't make up that first year of the royalty. Instead, you only make up that royalty at the very, very end and, in fact, if the northern parts of Alaska are even fractionally as productive as has been projected, you may literally never make up that royalty. So I think the simple proposition here is that the damages that would be sustained by the state from the non-development and non-marketing of North Slope gas would be enormous and, in fact, they relate directly even in the event there is simply delay, it is not enough to five years from now come back and say okay, now we are willing to do what we should have done five years ago.

Finally, we can briefly talk about the antitrust claims for concerted refusal to deal. We cite the authorities in the paper with respect to the Sherman Act claims and the monopoly claims, monopoly leveraging, etcetera. While we are not here today at all to say that an antitrust violation has occurred, it is our belief that should there be a concerted refusal to deal with respect to this gas, that that would be violative of the antitrust laws. The problem -- and just to put in perspective how such a situation could occur and why it might constitute a restraint of trade -- can kind of be seen in the chicken and egg situation that the state's been in now for 30 plus years. Obviously, gas is not like oil. It can't be trucked away or picked up by rail. It cannot be marketed without a pipeline. However, a pipeline cannot be built without the assurance of gas and so you have to figure out where do you start on that equation. We believe that it would be a concerted refusal to deal actionable under the antitrust laws if there is a failure to build a pipeline and, in turn, a refusal to sell the gas to others who are, in fact, willing to build such a pipeline. The antitrust remedies, very briefly, include treble damages -- in other words, three times the amount of damages -- and there are special provisions for injunctive relief. This might be somewhat responsive to earlier questions about the time frame. It would be possible under an antitrust context to go in and see expedited relief from a court to order the sale of gas under reasonable market terms.

In conclusion, the bottom line as far as the duties and misconceptions that we've talked about, is, first, we believe the oil companies should make available the North Slope gas to the Port Authority and other competing pipeline projects on the same terms and conditions that are the industry norm. Second, that would allow the decision with respect to the pipeline to be based on which pipeline is best for Alaska and not on any perceived stranglehold that the oil companies do not, we contend, possess. Third -- and this is a last resort -- this is not -- I agree completely with Mr. Hosie that litigation is not the first option but if, in fact, there is a complete refusal to deal, we believe then fair competition would have to be required by legal means.

In conclusion, we believe as a consequence of the Port Authority's offer and, indeed, the market portions that are at work here, we no longer have a situation where Alaska's gas is stranded. Indeed, a market and an offer exists today for that gas and we believe that this body, working together with the executive, can, in fact, using the legal remedies that are talked about effectively get that gas marketed. Thank you.

CHAIRMAN: Thank you. Do we have questions from members? None? Mr. Hosie, I was wondering if you could come up. I just had a follow-up question. I'm not sure, perhaps both will want to answer. With regards to the concept -- if we have a standing oil gas pipeline and that's certainly -- the Port Authority's made a proposal -- Trans-Canada's been in negotiation -- and the producers say well, we have trouble deciding whether we should sell at the wellhead because you've got a standing oil gas pipeline proposal but we're not sure what our tax is going for or going to be just, you know, for the production. What right do they have to say we don't want to sell, we can't make a decision to sell until we get certainty on the way that the gas is going to be taxed in the field.

MR. HOSIE: If I may answer that first, they have no right to say that unless they can come to you and persuade you that absent that concession and that prospective certainty what would otherwise be an economic project is suddenly uneconomic. In short, it would have to be the pivotal point and -- because it really does -- I disagree with Mark on three things and one of them is that.....

MR. COTHAN: No history.

UNIDENTIFIED MALE SPEAKER: There you go.

MR. HOSIE: Mr. -- a history of mutual respect. One of them is that because the dollars are so enormous -- $20 billion -- if the project is marginally economic, I can't imagine a court saying you must go forward and risk $20 billion because things happen. Remember what happened to oil prices in 1986? Nobody thought that was going to happen but remember what happened. They remember. I mean, there's always risk and when you're talking about a sum this large, you better have a lot of room for comfort within that economic circle and so if fiscal certainty, if tax -- a guaranteed tax regime reaching forth in the future becomes the pivotal point economically, then they can certainly ask for it and then it's in the state's discretion to agree or not agree.

One comment on monopoly leveraging. Monopoly leveraging is not actionable in the Ninth Circuit. It is in some circuits. It's not actionable under the *Alaska Airlines* case in the Ninth Circuit. I truly think that it is not, *per se*, improper for the oil companies to say we don't want to sell to a pipeline because we have our own plans going forward and that was the second area of disagreement.

MR. COTHAN: Just to briefly respond, I don't think I disagree with what Spencer just said. If it was simply marginal, it would not -- we are -- that's not where we are today. We are in a situation where the oil companies are literally faced with a proposition where they have absolutely zero risk with respect to the pipeline. That is risk that is willingly going to be assumed by a third party. Those risks can no longer serve as a reason for inaction. The only risk that would be associated would be the commodity risk which, in fact, oil and gas companies have every day of the year and, in fact, if we look at the situation we're talking about, their expenditures would be so minimal and, indeed, according to every reasonable projection of prices, their return would be so extraordinary -- I mean, we're talking about profit levels here not in the hundreds but probably in the thousands of percentage if you compare those two as to what they would make simply by saying yes to an offer to sell to a pipeline such as the Port Authority and so in that regard, I don't disagree that if it was just tiny, just, oh, gosh, real close, I don't disagree that a court might recognize the ability of the oil industry to there make the decision but that's not remotely the circumstances that the Port Authority's offer has placed firmly before the oil companies.

CHAIRMAN: Other questions? Is it possible to get a printed copy, please, of your PowerPoint presentation?

MR. COTHAN: We would be happy to do that.

CHAIRMAN: If there are no further questions, thank you very much for your presentation today. Thank you, members, for sitting through. I know we all have busy schedules but we felt this was a very important topic to be discussed at this time. Representative Samuels?

REPRESENTATIVE SAMUELS: Thank you for that. House members, I got a note from the Speaker's office. We'll go back in at 5:30.

CHAIRMAN: The meeting is adjourned.

(Off record)