

Arco

Briefing

CORPORATE FOCUS

Arco Proceeds With Ambitious Exploration Program

Despite Lower Earnings, Company Keeps a Long-Term Perspective

By **FREDERICK ROSE**
Staff Reporter of THE WALL STREET JOURNAL

LOS ANGELES—On a clear winter's day, Atlantic Richfield Co.'s chairman and chief executive officer, Lodwrick Cook, can see miles from his 51st floor office, to the mountains that rise east of Los Angeles.

A more important long-range view is far cloudier, this one economic. Yet major oil companies must plan far ahead on expenditures of billions of dollars for petroleum exploration and refinery modernization, commitments stretching well beyond the current economic horizon.

So even as earnings decline, Arco has embarked on an ambitious overseas oil exploration campaign and plans major refinery changes.

"We're trying not to yo-yo the company just because we're in a downturn," Mr. Cook tells a visitor after an early-morning exercise session. "We don't want to cut just to make the next few months look better."

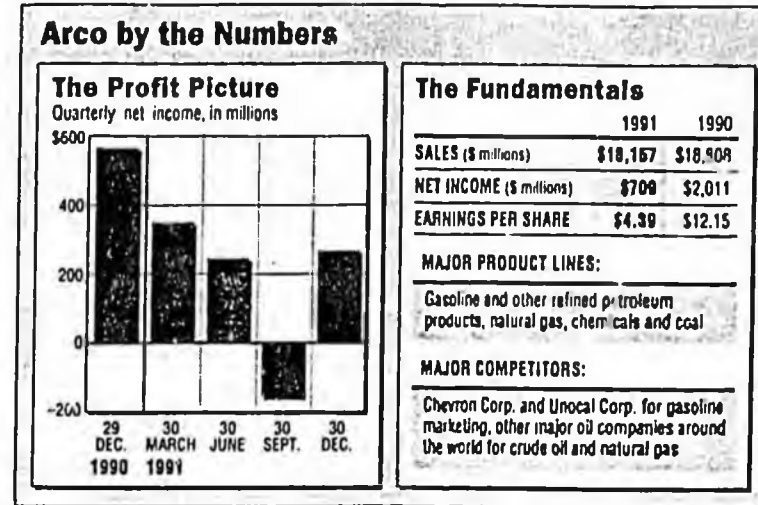
Though it has reduced its overall U.S. work force by about 7.5% because of problems in domestic natural gas markets, Arco has maintained its oil exploration and development budget this year at about \$1.32 billion. Moreover, it plans ambitious changes to its refineries to meet newly mandated standards for clean gasoline.

With earnings and cash flow off of late, the company has less financial maneuvering room than in past years, Mr. Cook concedes. "We have to manage ourselves through this recession, avoiding ways that damage the future," he adds.

The profit squeeze on oil companies has become even more apparent in recent days. On Monday, Arco reported a 53% plunge in fourth-quarter profit, to \$265 million, or \$1.67 a share. Revenue for the latest quarter fell 16% to \$4.83 billion. Other West Coast rivals were even more pressured. Chevron Corp.'s profit tumbled 94% from a year earlier. And Unocal Corp. had a \$16 million loss. Elsewhere, Exxon Corp. and Mobil Corp. recorded lower profit.

There has been "a dramatic change in the operating environment," Mr. Cook noted in reporting lower profit. Oil prices and particularly natural gas prices remain at low levels. Refining and marketing profits have narrowed substantially. And, though directors boosted Arco's dividend by 10% a year ago, they passed up the chance to do so again recently.

Now, Mr. Cook, who is 63 years old,



says he will stay two years past the company's mandatory retirement age of 65, holding the office through June 1995. "There are a lot of good challenges out there that need continuity," he says, "I think the board took that into account when deciding on this plan." Not incidentally, Mr. Cook hopes to be around for better times. "It gives us more time to get back on that northeast curve, which we like," he adds.

All of this is a sharp change from the recent past, when Arco posted record profit and its stock soared above competing oil companies. Through the 1980s, the company grabbed big chunks of the West's high-profit gasoline markets and became the region's largest vendor. Its marketing strength was balanced by the company's already formidable crude oil advantage from its stake in the giant oil field at Prudhoe Bay in Alaska.

Long-term questions lingered about Arco's Western focus and its reliance on Alaska's now-mature oil fields. But it was the recession and the company's lower profits that focused critics' attention on the company's long-term problems.

Even in tough economic times, Arco needs to pursue plans it made a while ago to improve both refining and marketing operations and to assure crude supplies for the last part of this decade and beyond.

Arco must spend \$800 million on its Los Angeles-area refinery alone, modernizing it to make the cleaner gasoline that will be required by California regulations in 1996. Arco has committed hundreds of millions

of dollars to sustaining oil production at Prudhoe Bay. But perhaps most important to the company's continued success, billions of dollars more will be poured into exploring for oil to replace now-dwindling Alaskan production.

These projects call for total corporate outlays of between \$2.5 billion and \$3 billion a year at least for the next several years, Mr. Cook says. That is somewhat higher than the \$2.4 billion total it plans to spend this year corporate-wide, including not only exploration and development but also refining and marketing.

"We're doing all the things we're supposed to be doing—thinking and planning long term," says Mr. Cook. But taking the long view can be painful in the short run, and thus the irony of Arco's plight.

Arco has taken a beating from investors, who have sent the once-favored oil stock sliding about 9.6% in the past three months, a drop nearly three times steeper than its peers, on average. Arco shares were quoted at \$108.125, down \$2.375 in late New York Stock Exchange trading yesterday.

Moody's Investors Service Inc. and Standard & Poor's Corp. both recently considered downgrading the company's debt. Though Moody's left its single-A-1 rating on Arco's \$5.6 billion in long-term debt, Standard & Poor's downgraded the corporate paper a notch, to single-A-1, its second-highest grade.

"Atlantic Richfield will walk a tight financial line over the next few years," Salomon Brothers analyst Bernard J. Picchli

predicted recently, adding that, after the company's big projects, "excess cash will not be very great."

Arco has carried a more heavily leveraged balance sheet than most other oil companies for some years. Debt at Sept. 30 made up about 47% of its overall capital, nearly twice the industry average of about 24%. "There's no question that we're more leveraged than some of our competitors," says Arco's chairman. "We feel comfortable there; this isn't a time to grow."

Leverage, says Mr. Cook, is part of Arco's tradition. "We like to feel under pressure," he adds. Indeed, in the 1970's, as it financed a sizable chunk of development of the Prudhoe Bay oil field and the 800-mile Trans-Alaska Pipeline System, Arco's balance sheet was burdened with loans. But, when operations started and cash poured in, debt dropped to 25% or so of overall capital. Then, in 1985, Arco nearly doubled its debt in a single stroke by borrowing billions of dollars to buy back about a quarter of its shares.

Analysts often have taken Arco to task even in the best of times. "Not long ago, everyone was worried that we would make a huge acquisition; now the complaint is that we have too much debt," Mr. Cook grouses. "It seems that analysts always need something to worry about."

Other major oil companies suffer a similar "Catch 22," notes William H. Brown III, analyst at Kidder, Peabody & Co. Big companies, he says, have big needs. While a single oil discovery may mean a huge jump in reserves for a small company, major companies' oil reserves are so big that a single roll of the dice won't do. Instead, it takes many successes to make meaningful additions. "There just has to be a minimum maintenance level of exploration spending," says Mr. Brown. So major oil companies haven't yet slashed capital outlays.

At the same time, there isn't much opportunity for day-to-day cost-cutting. As oil prices tumbled in the 1980s, producers slashed overhead and employment, cutting costs long before the recession hit. "These companies are reaching their terminal cost reductions—unless they sell assets or severely reduce operations," Mr. Brown says.

That could be in the cards for Arco. Although Mr. Cook thinks his company's course is set and is reluctant to "jerk the company around," he adds quickly: "If we find ourselves at the end of this year, and things haven't evolved as we anticipated, then we'll adjust."

Jim Davis
February 4, 1992
Address to Legislators

I very much appreciate the opportunity to talk to you today about the petroleum industry and the outlook for its future in Alaska.

As you may know, the suggestion for this informal briefing came from casual discussions last fall with several of the committee chairmen and ARCO Alaska's senior staff. It was suggested that the key House and Senate committees would benefit from an ARCO overview of the current state of the oil and gas industry in Alaska.

Given the sharp decline in the price of crude oil since those fall discussions, and its direct negative impact on the FY92 budget and the FY93 revenue projections, it seems particularly appropriate that we offer our thoughts to you today.

In particular I am going to concentrate on exploration, for it is the cornerstone and future of the industry. To state the obvious --you can't produce what you don't find. My job for ARCO is to find it.

I will offer you some reasons why a number of companies are abandoning Alaska exploration efforts--and why ARCO, the state's most active explorer, is continuing with its high level of effort. And I will suggest what the state can do to encourage other companies to invest in exploration in Alaska.

In view of the fact that more than 85 percent of the state's income comes from royalties and taxes on oil production, it is disturbing to see that the Alaskan rig count ended 1991 at its lowest level in 17 years. There is not much promise of improvement for 1992.

If the oil industry is to remain healthy in the long term, we must continue to explore for new sources of oil and we must be successful. We must efficiently maximize production from existing fields, and in the face of lower oil prices and tougher competition, we must cut the cost of doing business.

ARCO Alaska is doing all of these things.

In terms of exploration, ARCO plans to spend \$600 million in exploration in Alaska over the next five years. In 1992, we expect to see between 15 and 25 exploration wells drilled in Alaska, and ARCO will participate in 75 to 80 percent of those wells.

In Cook Inlet, there is cause to celebrate the discovery of oil at the Sunfish prospect. A jackup rig is overwintering at Nikiski to drill a followup well next summer, to further evaluate the discovery.

This winter, ARCO has five drilling rigs at work on exploration prospects-- the most activity of any company in Alaska. This includes the BLT well north of Anchorage, where we are looking for gas. This is a unique area in that the mineral ownership includes some private land. We have paid over \$400,000 to individuals for those rights. The state has also realized over \$2 million in lease bonuses. And the local economy benefits from 37 local people who are employed at the rig site, and more than \$1.5 million spent locally for services and supplies.

ARCO also is drilling the Cabot prospect in federal OCS waters offshore Barrow, which is the third Western Beaufort Sea exploratory well. If the Cabot well is not successful, it will may be the last in the area for some time.

And we recently spudded two wells in the Colville River delta, west of Kuparuk, which will be followed by three more wells this winter.

ARCO is looking for partners to explore the Kuvlum/Maktar prospect in the Eastern Beaufort. This prospect is important in proving up enough reserves in the area to justify shared production facilities and a pipeline to the trans Alaska pipeline. Unfortunately, several companies who had planned to participate have pulled out, and if that well isn't drilled this year, I fear it won't be drilled before leases expire. That could mean the end of activity in the Eastern Beaufort for the foreseeable future.

ARCO is the only company active in the interior basins. We have an agreement with Doyon in the Kandik Basin, near the Canadian border, where we have completed extensive geological studies and seismic and other geophysical studies. We are researching new drilling systems which are less costly and have less impact on the environment. We are looking for a partner to help us drill the prospects that have been identified.

This exploratory activity is aimed at preserving ARCO's future in Alaska.

Meanwhile, in order to maximize recovery from Prudhoe Bay, ARCO and its partners are making major investments, totaling more than \$2 billion, in gas handling facilities to make it possible to recover more oil from the reservoir.

When the field went on production in 1977, we expected ultimate recovery to be 9.6 billion barrels of oil. Today, we expect to recover more than 12 billion barrels. This increase didn't just happen. It is the result of aggressive investments in wells and facilities, technological advances, and the considerable efforts of a lot of people.

And we are cutting costs. Recently, we took the very painful step of cutting some 250 of our 2,900 Alaska employees. In addition, ARCO and BP are streamlining operations at Prudhoe Bay through consolidation and sharing of services. That meant the loss of 100 jobs, many of them contract employees.

Other oil companies, including many who do not have current production in Alaska, have announced in recent months they are giving up their exploration efforts in Alaska and intend to invest their exploration dollars in foreign countries.

This is disturbing news because it is in both the state's interest and ARCO's interest that Alaska maintain an aggressive exploration program, with a vigorous service industry supporting it.

You may wonder why ARCO wants competition in Alaska. First: given the high cost of exploration and the low chance of commercial success, we need partners to share the risk. Onshore, it costs from \$5 million to \$10 million to drill a single well; offshore, the cost can range from \$20 million to \$50 million or more. The only way to stay within a reasonable budget and still participate in a significant number of wells is to team up with other companies.

Second: Because of the way land is traditionally leased, in relatively small blocks, companies must form partnerships to create a leasehold large enough to justify an exploratory well. While we need such partnerships, coming to agreement on when a well will

be drilled, and how costs and production will be shared, is difficult, especially if the companies have differing views of Alaska.

Third: ARCO alone cannot support a viable service industry, to perform not only the actual exploration drilling but also to provide such services as earth moving, road building, well logging, well testing, camp building, seismic activities, and catering. As activity decreases, the cost of services increases, and so on. It's called a death spiral.

Now to a key question. Why is Alaska losing the battle for exploration capital?

To answer this question, we must understand a little about the exploration process. Exploration is a long term venture. Typically, it begins with broad regional geological studies of areas of considerable extent, involving areas of a few hundred miles square, or tens of millions of acres.

These studies reflect the fact that although the rocks have changed very little over human existence, our understanding of them is continually changing. To quote Parke Dickie, the pioneer petroleum geologist, "You can find oil in new places with old ideas, or in old places with new ideas. Seldom can you find oil in old places with old ideas. In the past, we thought we were running out of oil, but in fact we were running out of ideas." End of quote.

The next step in the exploration process is to conduct seismic and other geophysical studies over more local areas, tens of miles square, selected through geologic studies to be of the highest interest. Prospects identified then must pass rigorous economic screening before they are drilled. The economics include risk factors and costs of developing and marketing oil, if it is found.

This process takes at least five years, and must take place in advance of any lease sale. Once we are successful in acquiring leases through the competitive bid process, then the permitting process begins. An offshore well can require up to 30 permits or regulatory approvals from state, federal and local governments. Only when all approvals have been obtained can drilling begin. A delay of a few months can mean a year's delay in drilling where seasonal drilling restrictions are in effect.

The results of drilling that well, and perhaps others, are incorporated into existing geologic concepts and the process repeats itself.

If we are lucky and discover oil, another five to ten years will be needed for permits, design and construction to put the new field into production. Only then will we be in a position to begin to recoup the costs of exploration and initial development.

An example is ARCO's recent Sunfish discovery in the Cook Inlet. We began the basic studies four years ago, and developed new geologic concepts. In 1990, we tested these new geologic concepts by drilling the Sturgeon prospect at a cost of \$12 million. We didn't find oil, but it was a technical success because it confirmed these new concepts.

It encouraged us to drill the Sunfish prospect, at a cost of \$30 million. That was a successful test: We discovered oil! We are planning delineation drilling this year. If it is found to be economic, it will be five to ten years before production facilities are designed and the construction is completed.

Anything that adds uncertainty to this long-term process is undesirable because it increases the risk to the explorer and makes further exploration less desirable.

Uncertainty is one of the reasons the industry is exploring less in Alaska and the Lower 48 and is investing those dollars overseas. Just since 1985, the U. S. oil industry has increased its foreign investment from 40 percent to 80 percent of its total capital investment.

A recent Oil and Gas Investors article points out that democracies may seem inherently attractive and safe to Western eyes, yet they have a habit of making changes that affect the business community nearly as often as elections are held.

This is why the U.S. itself is increasingly regarded as being a high risk country compared to Canada, the U.K., or Indonesia, the article points out. "When viewing the spectrum of risks associated with foreign investment, the U.S. comes under a great deal of scrutiny. In terms of volatility and unpredictable tax law changes, the U.S. record is not the best." Unquote.

Uncertainty of regulation and increasing environmental costs could be added to this spectrum of risks. And exploration investments must be factored into companies' long-term planning.

Consider this analogy. Suppose you wanted to buy a lot on which to build a house five years from now. Say you had a choice between a subdivision in each of two towns. In one the town has committed to follow the building code standards that are recommended nationally and has a history of stable zoning and responsive permitting. The other has a history of imposing unique building codes, has no zoning, and is erratic in issuing building permits. Which lot would you buy? Would you even consider buying the latter lot?

The petroleum industry is faced with a similar decision. Generally speaking, an explorer overseas will know the taxation and permitting requirements prior to making any investment. In fact, foreign governments have shown willingness to be responsive to adverse conditions to accommodate marginal fields and hard economic times.

As an example: the government of Alberta has announced a royalty holiday for wells drilled in the next two years.

Companies also are not exploring in Alaska because they are being denied access to areas with oil potential, particularly federal lands onshore and offshore. Given the exploration process I have described, you can see it is impossible to know in advance precisely where your studies will lead you. Yet the federal government has withdrawn large blocks of acreage within offshore sale areas, leaving an unconnected collection of blocks. And the Coastal Plain of the Arctic National Wildlife Refuge, the most prospective onshore area in the U.S., continues to be off limits to exploration.

In the Lower 48, 40 per cent of the federal oil and gas lands on shore are now unavailable because of leasing moratoria or other restrictions. And there is a ban on offshore leasing from Maine to Florida and from Seattle to San Diego. For these reasons, the industry is not investing in pre-lease activities outside the Gulf of Mexico.

Industry has spent \$10 billion exploring the Alaskan OCS, through 1990, including 75 dry holes. More than \$6.5 billion of that went for

lease sale bonuses and rentals, while another \$3 billion went for actual drilling costs.

The majority of companies conducting Alaskan OCS exploration have had little participation in onshore drilling. Given the record of dry holes offshore, it should come as no surprise that these companies are reassessing their positions and are looking elsewhere.

Why isn't ARCO taking its exploration dollars out of the state?

Since the mid-eighties, we have had an exploration program balanced between the onshore and the offshore. With the troubles in the OCS, ARCO, unlike some of its competitors, was able to easily redirect efforts onshore.

We understand that exploration is a long term and technically based business. Over the past four years, ARCO has invested over 250 man years in basic regional studies of Alaska. This next summer marks the 37th consecutive year that ARCO has had geologic field parties. No other company matches that record. We believe these investments give us an edge over our competitors. This understanding has led us to aggressively invest in both state and federal acreage.

In addition, our people live and work in Alaska and are able to communicate routinely and in a timely way with the state agencies. But the most important reason ARCO maintains an aggressive exploration program in Alaska is that ARCO, or its predecessors, have had exploration success.

We made the discovery at Swanson River in 1957 that helped achieve statehood for Alaska. We also discovered Prudhoe Bay, Kuparuk, Lisburne, and Point McIntyre. Last fall, we announced a discovery at our Sunfish location in Cook Inlet. It was the first Cook Inlet oil discovery in 26 years.

ARCO is working hard to build a future here. Through continually evolving technology, we believe that Alaska offers a resource base that is as prospective as anywhere in the world. If we didn't, we would not be Alaska's most active explorer.

Let's look at Alaska's competitor countries overseas. Those countries offer a business environment that is compatible with the exploration process and encourages it.

They grant concessions on large contiguous blocks of acreage, from 250,000 acres to 25 million acres. Exploration rights are valid for a length of time that is appropriate to the process. Stipulations are known up front, including terms of operations, environmental requirements and development requirements. In addition, partnerships are known ahead of time as they are developed prior to joint bidding for the concessions.

Of course there are work requirements. But no company bids on these types of concessions unless they plan to conduct activities.

So what can the state do to reverse the trend to overseas investment?

For one thing, the state must be a strong advocate of a stable and truly area-wide federal OCS lease sale program in Alaska. And the state should also support the opening of the ANWR Coastal Plain-- not only for the windfall from bonuses it would receive, but because a discovery in ANWR could justify the construction of a pipeline to connect with the Trans Alaska Pipeline. Discoveries already made in the adjacent area appear to be too small to justify the costs of development. They most likely will not be developed unless additional reserves are found.

The state also must do more to entice explorers back onshore. While the state has done a good job in allowing access to state lands, and has provided reasonable stability in administrative processes, there is room for improvement.

We see a continual escalation of permitting requirements. Each additional permit is more stringent in its stipulations. The value of this escalation is doubtful, both from an environmental perspective and certainly from a cost/benefit viewpoint. As an example, it recently took three years to permit a new drill pad within the existing Kuparuk Field.

There is also opportunity to streamline the permitting process. More than time is lost in the maze of paperwork. ARCO employs 35 people full time, and others spend part of their time, to handle the permits

required to drill about a dozen exploratory wells each year, as well as for development projects in existing fields. If some of those people could be redirected to identifying exploration prospects, we could have a much better chance of finding the reserves both Alaska and ARCO need.

Another way the state could help is in encouraging the formation of exploration units. The exploration unit concept is a powerful way for the state to level the playing field in competition with other countries. It allows the combining of tracts with different expiration dates and different owners into a unit which is held together beyond individual lease expiration dates, as long as specified work is done.

We see the current process of forming units becoming more burdensome. What should take a week for administrative review by the state is now taking six months. The Legislature should let it be known that it supports this powerful concept and encourages the use of exploration units.

We are happy to hear that the state is considering the concession arrangement that is attracting capital overseas. The state and native corporations must work together, especially in the interior basins, to offer large blocks of land for exploration. It is an idea that could be used elsewhere in the state, in areas not adjacent to current production.

The completion of the state's land selections, which the Department of Natural Resources has identified as a top priority, offers a unique opportunity to aid the exploration process. Lands can be selected to preserve access to prospective oil and gas resources and for transportation corridors for pipelines, if exploration is successful.

It would be difficult to restore Alaska to previous high levels of exploration activity. But with the improvements I have suggested, I believe that the state can at least stem the tide of retreating exploration dollars and perhaps bring new life to Alaskan exploration.

I hope that this perspective is of help to you and I wish you all the best for this session. Thank you for your time and attention.

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John C. Roots
Vice President

January 6, 1992

Representative Bill Hudson
Room 114, Capitol
P.O. Box V
Juneau, Alaska 99811

Representative Cliff Davidson
Room 108, Capitol
P.O. Box V
Juneau, Alaska 99811

Dear Bill and Cliff:

As you are aware, I have scheduled ARCO Alaska's Senior Vice President for Exploration, Jim Davis, to provide an informal briefing to the Senate Oil and Gas and Senate Resources Committees the morning of Tuesday, February 4, 1992. Jim will discuss significant oil and gas issues, including current exploration programs and recent discoveries in the Cook Inlet area. We would like to offer the same briefing to the House Oil and Gas Committee and House Resources Committee the afternoon of February 4. If this is convenient, I will make the arrangements with Jim.

Sincerely,

Vice President
Political Affairs

s b

c: Senator Sam Cotten
Senator Lloyd Jones



Alaska State Legislature

HOUSE OF REPRESENTATIVES

Official Business

State Capitol
Juneau, AK 99801-1182

January 24, 1992

Mr. John Roots,
Vice President
Political Affairs
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Dear Mr. Roots:

As earlier discussed, the House Special Committee on Oil and Gas, jointly with the House Resources Committee, will be pleased to receive a briefing from Mr. Davis, ARCO Alaska's Senior Vice President for Exploration on February 4, 1992 at 3:00 p.m.

The issue of current exploration programs and recent discoveries in the Cook Inlet area are of extreme interest to both committees.

Respectfully,

Handwritten signature of Cliff Davidson.

Cliff Davidson, Chair
House Resources Committee

Handwritten signature of Bill Hudson.

Bill Hudson, Chair
House Special Committee on Oil
and Gas

:lh

cc: All Members Oil and Gas Committee
All Members House Resources Committee

Alaska Sedimentary Basins

