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Alaska State Legislature

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TRANSCRIPT OF TESTIMONY OF

MILTON LIPTON

March 15, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:

Chairman Mike Colletta
Pat Rodey
Bill Sumner
John Sackett
Kay Poland

Representatives:

Chairman Bill Miles
Chat Chatterton
Joe McKinnon
Charlie Parr
Al Osterback

CHAIRMAN MILES:

I'll call the committee to order. Senator Hackney, would you care to join us? Senator Sackett? We'd be more than pleased to have you. We have with us tonight Mr. Milton Lipton. He's going to give us some of his observations on the contract. He's certainly well known to all of us. So with that, Mr. Lipton, please --.

MR. LIPTON:

I'd like to ask Mr. Kildrum ^{Lilgore} (ph) my ^{associate} ~~assessor~~, to join me. I don't mind volunteering observations to the committee but if the questions get too difficult, I'm going to throw them at Dick.

Your committee's obviously been close to this issue for a long time, a lot closer than we have been and when we met the latter part of January, you asked me if I would comment on the subject of the oil royalty contract. At that time it was still in the competitive stage and I offered some very general observations on what I saw were the critical considerations involved. I will not repeat myself to you.

UNIDENTIFIED SPEAKER:

Mr. Lipton, I'm having a little bit of trouble hearing in the

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back.

MR. LIPTON:

Well I'd be glad to address myself to the ALPETCO group, but that would mean turning my back on the committee. Does this do it, does this help?

UNIDENTIFIED SPEAKER:

No, I think that's just a tape recorder. You have to move forward.

CHAIRMAN, MILES:

You just come on up.

MR. LIPTON:

I'll try to talk louder, not better but louder. Really, we have put together, I think, three observations about the contract that is now in front of you. And I think one footnote to the three observations, and I'll try not to be long-winded about these, and then place myself at your mercy for whatever questions you would like to ask.

I start with the first observation which is that if the royalty contract placed before you is approved by the legislature and if it comes to fruition, there are some very definite advantages for Alaska. And I see these as especially significant in the light of the fact that when the issue or the subject or the possibility of the sale of royalty oil as the basis for some kind of industrial establishment was first (indisc. - cough). The companies that are most likely to be parties of the first part, rather they are oil companies or chemical companies, were extremely reluctant to come forward with positive commitments. We know this because among our clients were companies that really discussed the prospect and many of them looked at it, some seriously, some less than seriously. But in light of the fact that the companies who might have had the best controlled markets for the disposal of either energy products or chemical products were themselves reluctant or didn't visualize the prospects as particularly conducive or were reluctant to make the investment, that in consideration of all of this, it stands as significant that there is a contract before you with a group who if they can perform and if it comes to fruition would contribute something that otherwise you have been unable thus far to get. And that in itself I consider to be a plus for what has been the process of investigation, discussion and negotiation up to date. That's my first observation.

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I skip to my third observation, and that has to do with how we see the prospects for success. Now I speak of this, not in terms of the probability, it is no part of our role to tell you what the chances are of this thing coming to fruition, but I think it is important to evaluate again what the difficulties and what the problems are. Particularly, because in all of the discussion and in all of the representation there has been a great deal of possibly and probably, and sometimes not coming to what we think are the realities of the project, or any project faces.

The disposition of chemical products on the West Coast is, I think, a reasonable possibility; that is to say there is a great market at the present time which is supplied by indirection out of capacity in the Gulf area. The market is undoubtedly growing. One can argue about rates of growth in the United States or in world markets, and I put that aside. I don't think this is a numbers game. But there is a potential market on the West Coast.

The difficulty, of course, is that the companies who are in most direct control of the market are not the ones who are participating here. It becomes a matter of whether one can establish the relationship which makes it possible to do.

I think that the foreign market, which is discussed, which is essentially the western perimeter of the Pacific, is probably the most elusive and the most difficult one. It's not because there isn't going to be a growth in chemical demand in Japan, Southeast Asia, and the Pacific basin as a whole; there will be a considerable increase in demand. But the areas from which that chemical demand can be supplied looks to be ever so much more attractive than out of Alaska. I'll give you our quick thinking on this.

The expansion of chemical capacity to serve the markets by Japanese chemical companies is undoubted. It is going to happen. The question is from where. For a lot of reasons we think that the major expansion of chemical capacity by Japanese companies will not be in Japan. It will be outside of Japan. There are limitations on what can be done in Japan for a lot of reasons, not the least of which has to do with siting problems, has to do with environmental problems that are very, very real. But it means that if the Japanese chemical companies are going to export capacity, they will export capacity to those areas where it is most strategic for them to do so. And that means either exporting the capacities, say, into Southeastern Asia, the whole range of areas all the way from Taiwan, through Singapore, potentially through Indonesia, where in a sense they are in the direct line of the main flow of feedstocks from the Persian Gulf area, the Arabian Gulf area, to their markets. Or, they will participate directly, or indirectly, in the expansion of

petro-chemical capacity in the Middle East itself.

I think there's some misunderstanding about what the incentives are for investment in the Middle East. It's true that capital costs are relatively high there, but the decisions of companies whether or not they put their capacity into the Middle East, where capital costs are high and where transportation costs to market for petro-chemicals are high, better moving the crude oil from the Middle East to Southeast Asia, the naphtha that comes with the crude oil, you process the naphtha. Given the transportation disadvantages and given the capital disadvantages, the reason that the companies are considering going in there is not just that they get an assured supply of petro-chemical feed stocks (ph), which is the argument in behalf of the Alaskan facility, if in the future period of time there is question about the continuous availability of feed stocks (ph), shouldn't you go where it is available - Alaska or Middle East? It is more than that. It's that there is a political thrust on the part of Middle East governments - Iran, Saudi Arabia, especially - to develop an industrial profile for reasons that are difficult to follow. I don't know the reasons for it, but to develop an industrial profile which somehow is a reflection, also, of their importance in the world at large. They aren't important in the world, because Saudi Arabia is going to be pivotal to the supply of oil and gas for the world. Why an industrial profile that reflects it? Certainly not to create unemployment. They don't want unemployment of Arabs, and they have great concern about the importation of foreign labor that might work there. But I think there's an important psychological urge that, if Saudi Arabia is to occupy as pivotal an economical and political role in the world as they now believe they can, and as the world outside tells them they must, that somehow they ought to look the role as well as play the role, and this involves some kind of an industrial profile which fits in with everything else.

Now, to do that, they have not only to offer the feed stock (ph) for the petro-chemical plants, and as a considerable negotiation, what price ethylene to an ethylene operation, and how do you handle financing, more important than that, and this is what brings in the Shells and the Mobils and the Dows and, in due course, the Japanese, that they're prepared to offer, in addition to the assured feed stock (ph) near the petrochemical plant, a collateral supply of crude oil for export purposes. The investment in the petrochemical facility will not only directly or indirectly overcome the competitive disadvantages, which you have in Alaska and which they have also (high capital cost, high transportation cost), they can put in the at a very low price if they will, they can offer low-cost capital advances, but there is a hundred to a hundred and fifty thousand barrels a day of crude oil, which in the late 1980's will be available to the company that is willing to make the petrochemical or the refining investment. And this is what is bringing the facilities into it. And this means you will have, not as quickly as we had anticipated had been brooded about,

and not on the scale that originally went into the Saudi-Arab investment program. And, in view of the surpluses, neither the companies nor Saudi Arabia are that anxious to push the thing along, which is one of the reasons the negotiations proceed.

But there will be, in due course, a reasonable expansion of petrochemical facility in the Arabian Gulf and in the Persian Gulf, because the Shah will have at least one major facility. This expansion, which willy-nilly is going to have to move to world markets and which faces special competitive disadvantages in the European market, or the U. S. market, transportation problems, no quick mode of transportation, the kind of ocean-going carriers that are lowest cost probably couldn't go through the Suez Canal - what goes through the Suez Canal is higher cost transportation - plus protection in Europe by the Common Market for their own chemical industry, so worthily (ph) you are looking at the western rim of the Pacific, which is precisely what Alaska would hope to get to augment whatever the potential is in California. And if the export of processing capacity by the Japanese chemical industry to Southeast Asia, coupled with the competitive supplies out of the Persian Gulf are put together, what it means, in effect, is that the present capacity in Japan, which is both for domestic and export markets, becomes increasingly available for domestic markets, because the export markets get served out of the export capacity to other areas.

This is why we feel that it is extremely difficult to visualize the (indisc.) of commitment of Japanese, because given the proper terms and conditions, there may be certain commitments. But the way in which the competitive environment operates in '85 and '87 and in '89 when an Alaskan facility comes on (indisc.) and they may have to supply parts at not stipulated prices, but at what are called competitive prices, I think both volume and price-realizations are questionable. The point of what I'm saying here is not that I'm trying to tell you the odds of the project coming to fruition, that's not my point. I think that you've got negotiated, both by the State and by the ALPETCO group, as an imaginative combination of factors into a contract as you could get, particularly in view of the fact that nobody else was forthcoming. What I'm concerned about is my point two, which I now come back to. Namely, what are the risks for Alaska? Because, if the project can be put to fruition, but if the economics should turn out as complicated and as difficult as we think they will, then this raises the whole question of what the risk is for Alaska. So I come back to this, which is the in-between thing.

Yes, it's a heroic effort on both parties' parts, and I think a very carefully drawn contract.

Number three - we think there are problems, And, if we are right about the problems, but meanwhile the contract is moving forward, what are the risks for the State of Alaska?

I suppose that in the interim period. they are pretty much minimized by the terms of the contract. There are due dates and performance commitments right down the line. So how can Alaska really lose on it? For example, the ALPETCO group, which for reasons that I can only partly interpret, would like to have prior access to the crude oil before the facility is completed. Obviously, if they have that option, and in eighteen months they have met their commitments, they would only exercise their option for the crude oil if it turns out to be profitable for them to do so.

But, how much protection does Alaska have in this interim period? Well, the due dates are very clearly specified. There are certain allowances to the Commissioner six months at various dates (indisc.). But, you know, I rather suspect that if this group works as hard as they obviously intend to, that if there comes a due date and there is evidence of sincere effort, will Alaska at that time say, "Cut them off because they haven't met their commitment," or will you be more inclined to say, "Well, look, all the evidence of effort is there - one is on the verge, shouldn't we go?" Which means one may extend all of these due dates somewhat beyond the contractual terms, which may not be bad. The only question then is, for how long a period of time has Alaska, in a sense, given the first option for all proposals to this selected group and, during this interim period which may be assured is eighteen months, but may be as long as two years or two-and-a-half years, which in effect blocks out any alternative proposal. I have no idea if alternative proposals come in, and I don't weigh this very heavily. But in my own mind, as I visualize the progression through which one goes, one has to ask realistically whether a due date at which point performance has been completed or the contract is voided is really realistic. If in fact this group will perform, as I expect they will; that is, with diligent effort and always with the expectation that things will be coming through. But more importantly, your contract is a contract contingent upon a whole series of performance. The ALPETCO group must also look for the contracts which they need, both for off-take of products and for the commitment of funds, which, in a sense, are contingent, too. That is to say, as long as things continue to look prospective, one goes along.

What is a contract for the off-take of products? Specified products, specified quantity into a certain market at what? At a guaranteed price? Never. It's also got to be at a price which allows the buyer to be competitive in his own markets. Call it what you will - world market prices, competitive prices, whatever it is. And so long as things are running this course,

and in every stage of the game there may very well be a feasibility study, one goes along; which means the lenders do, the ALPETCO people do, and the buyers do. But, if, finally, this facility is built and if you have five difficult years in which the lenders can be satisfied but the profitability of the refining bill really isn't there, that is to say, there would have to be capital infusions to keep it running, does the group have the financial capabilities to weather five or six years of difficulty beyond which the project may work out fairly well? Maybe not, but it could very well be. Or, does it become the responsibility of Alaska, in a sense, to provide them with essential support in the expectation that things will be better. The light at the end of the tunnel and the way you do it is you turn the equation around. The equation today is that the feed stock (ph) costs are fixed. They'll make a profit by selling competitively. You may have to turn it around that the selling price of the products is determined, and in order for the thing to survive, you have to adjust the feed stock (ph) costs to what the market looks like. This, I think, is the risk of Alaska. I'm not trying to pre-judge it. This is not a forecast, but I think that if you look at the combination of realities which the group faces, it is less disadvantageous for Alaska, but the realities stop the project, in a sense, and made a good pass at a Royalty crude contract but it hasn't worked out. Then that always the prospect is leading you one step further and then Alaska gets in the position where it, willy-nilly, is party to the equity position of the project because it will be very, very difficult for a billion, a billion-and-a-half, two billion dollar project in which the state has a vital interest to suffer financial disabilities and maybe threaten some future viability, which is only two years down the road, a few years down the road, or four years down the road. This, I think, is what you must assess.

And, as I said last time, and I simply quickly summarize. In the state of the circumstances, if you the Legislators have significant doubts about the balance between the benefit to Alaska and the risk, I don't think Alaska loses too much by deferring the decision. This, of course, is contingent upon whether you think royalty oil will be available in the future, whether you think one or two years or three years of draw-down of reserves is going to prejudice your ability later on. But the way in which one sees the future suggests that the perception of all parties as to the value of assured access may improve over time. And, there's no question about it, that the success of this project depends upon the participation of other participants, and the stronger the other participants are, the more closely entwined they are, the more they appear as a party of the first part, the more chances there are for success.

What you are wrestling with here is outside financing, outside marketing, all contingent upon the performance of other parties

and with an imaginative and an aggressive effort by the ALPETCO group, but with limited capabilities on their own, as we see it.

Now, just one footnote to all of this, and then I give you your crack at me. I say this because we have just come this visit and the previous January visit and last year and the year before with long discussions about the adequacy or inadequacy of the state's income tax. In reaching out at the income generated by operations here in Alaska, and there are bills to change the income tax - I have no idea where they are going - but let's assume now that the income tax remains as it is, which means that for any multi-state corporation the income which you can tax here in Alaska is not measured by the profits in Alaska but is measured by the allocation of their overall profits earnings allocated by formula through Alaska. And, as you know from long discussions, the big deficiency in the formula is that the sales factor gives you virtually nothing. You produce a lot of oil, or you might refine a lot of oil, or refine a lot of petrochemicals, but very little of it is sold in Alaska. So the proportion of a corporation's, of a multi-state corporation's total sales, which are sold in Alaska and become very small. So little of the income is allocated here.

I know very little about the internal structure of ALPETCO now, let alone what it may be by the time the project comes to fruition. But to my mind it is quite conceivable that it will be engaged besides petrochemical operations in Alaska with at least transportation and perhaps some satellite projects. They would like to get as much of the down-stream investment up here in Alaska, but they may be involved in California. I don't know.

What I'm suggesting is you might want to consider that if the state feels positively inclined that you might at least consider that part of the arrangement between the state and the group shall be that the first sale of products out of the facility shall be made in Alaska. It doesn't mean it stays in Alaska, but it can very well be exported. But if the first sale, whether it's to a trading company or to whoever, takes place in Alaska so that one comes to reckon what the earnings are, subject to tax, apportionments, or anything else, that at least you have under your present income tax statute and under your present allocation formula, at least you have a leg-up that there is a reasonable proportion of the product produced in Alaska is also sold in Alaska so that for tax purposes at least it get allocated back here. Which means you're not increasing the tax burden on it, but what you're saying is you have at least a chance to identify and reach out and tax it. This is a footnote, and it comes up only because this whole issue of the income tax has been so much in the fore for such a long time and we've been pivotal to that discussion. So I think you may want to consider that.

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CHAIRMAN MILES:

Thank you very much. It's always a pleasure to have you come before us. Are there any questions from the committee?

MR. CHATTERTON:

Yes. I'll strike out first, Mr. Chairman, if I may.

Unequivocally, Mr. Lipton, you feel that a sale of our one-eighth royalty oil, that there is a risk attached to it. A risk that we might end up getting less for that one-eighth than if we took it back.

MR. LIPTON:

There is a risk. There surely is a risk.

MR. CHATTERTON:

I'm curious if you are somewhat acquainted with the State of Alaska's Constitution. Over the years you've been coming up here, it more less states that the resources of the state belong to the people. I'm wondering if you would care to make a comment as to whether or not we, as a Legislative body, have the moral or even constitutional right to take a risk with the peoples' money, or would the people go after it.

MR. LIPTON:

Well, you put your questions very, very directly, and it's awfully hard for me to equivocate when you put them that way, and I can't. Yes, I think you have a right to take the risk because you always take the risk. You take the risk in every kind of a lease sale. You take a risk when you select the bidding variable for a lease sale. You take a risk when you decide on how you choose among tax alternatives. These are all risks. I guess, unequivocally, I've got to say yes you have a right to take a risk on this, also.

MR. CHATTERTON:

Okay, fine. Fine. Thank you.

MR. PARR:

Mr. Lipton, if I understood you correctly, I think what you saw as the main advantage of this whole contract operation is that you got a breakthrough. You finally find someone who is willing to stick his neck out and go for a petrochemical complex in the West.

MR. LIPTON:

Gee, you put it so simply, and I was so complicated. Yes.

MR. PARR:

Okay.

MR. LIPTON:

That's it.

MR. PARR:

The second thing. . . I'd like to paraphrase what you said to make sure I've understood it all. There's going to be growth in the Japanese petrochemical industry. Most of it is going to be exported capital growth. They're going to build the plants either in Southeast Asia or in the East. And those . . .

MR. LIPTON:

For a specific market. For a specific market.

MR. PARR:

And those plants are going to take care of the export business. The plants that have been formed that are rather old-fashioned, using naphtha which are now in Japan itself will be servicing their domestic market.

MR. LIPTON:

Increasingly, yes.

MR. PARR:

Yes. What is the general status of the ability of those plants remaining in Japan? Those domestic plants we have been told, at least, are rather old-fashioned, to compete with a modern plant now coming on the line; but coming on line in 1983? Given their advantage of being on the spot.

MR. LIPTON:

Well, look, it depends upon what the ingredient of the competition is. Uh, in many respects a depreciated plant has a tremendous competitive advantage over a new plant if you're talking about relative costs of production, relative costs of processing. It depends how you calculate the costs. If you're saying, if you're looking just at operating costs, they may not be that competitive. But if you're looking at the whole complex of costs that go in with a great deal of the capital investment written off, and

you're looking only at the incremental cost of operation, they can compete. Hell, some of our oldest plants in the U. S. Gulf are competing in world markets today. And, so

MR. PARR:

You mean, in that case, that the advantage of having depreciated their plants already outweighs their technological backwardness. Is that what you are saying?

MR. LIPTON:

I'm not even sure how technologically backward they are. You know, it's an interesting question as to which technology is going to be the most competitive. Because technology is also a function of the feedstock that you use. Now, you know the new generation of ethylene plants, which are coming on stream in the U. S. Gulf and which is proposed here, are gas-oil plants which, basically, have a somewhat higher capital investment required relative to a somewhat different mix. But it's not at all clear that the direction in which the world petrochemical capacity is moving is going to move more and more towards the heavier feedstocks rather than the lighter feedstocks. Because if you go towards the Persian Gulf or the Arabian Gulf, you're talking about a fantastic availability of ethane, which is lighter material. If you look . . . I don't want to get more complicated than is necessary, but, if you look at the projects for the development of natural gas and natural . . . LPG liquids. Now there's talk about can you have an LPG base petrochemical operation here in Alaska? It's one of the things that's been considered. The amount of LPGs which are coming out of the Arabian Gulf between now and the early 1980's firm, and prospectively by '85, '87, and '88 suggests that propane, which has never been the basis for petrochemical processing in the whole Eastern hemisphere, although there has been to an extent in the U. S. Gulf, may become a competitive factor for petrochemical processing.

So, it's very difficult. I really don't want to substitute my judgment for somebody else's. All I see are so many uncertainties in the picture. But it's very, very hard to say with the kind of confidence that I would like to say that if only you have an assured source of feedstock here in Alaska, that outweighs your competitive disadvantages. And your competitive disadvantages are very clear. You heard . . . I don't even want to repeat it. . . you've heard this so much. The question is, does the assured availability outweigh the competitive disadvantage. It may for the Western hemisphere, and you may even get Japanese participation here for world markets, not on the Pacific rim - the Western Pacific rim, but for the world markets in the Western hemisphere. The Japanese are very active here.

They want to make an investment, which would be fine because they like to diversify their investment, and the Western hemisphere looks very good to them. But that's not the marketing output over there. And any way you look at it, you're moving against the mainstream of the flow of energy commodities and the buildup of energy values. You're pricing . . .

MR. PARR:

I'm sorry, I don't follow you.

MR. LIPTON:

The center of pricing for energy commodities and derivatives will be increasingly, it almost is today, but not quite, increasingly out of the Arabian Gulf. And as you move eastward, it builds up in cost. True. But, if you're going to move against that, it builds up in cost more and more as it comes toward the U. S. East Coast. And if you have crude oil out of Saudi Arabia, or whatever else, or the naphtha which is derived from the crude oil, or the gas oil which is derived from it, it all builds up in cost and, therefore, in value as you reach the U. S. West Coast. Well, you have a better competitive value in the U. S. West Coast, but if you start moving with transportation costs against that flow, you're moving further and further in the direction in lower cost feedstock (indisc. - cough) cost alternative feedstocks. Whether they are naphtha or whether they are gas oil or whether they are ethane in the Persian Gulf area, (indisc.) the Arabian Gulf itself, or whether they are LPGs.

MR. PARR:

You say moving against that flow you are talking about, in other words, trying to supply markets which are nearer to the Mid East. .

MR. LIPTON:

Nearer to the place where the price originates. That's right.

MR. PARR:

Now I'm with you. I think I'd like to look at this a little further.

CHAIRMAN MILES:

Mr. Lipton, in there, speaking directly to the contract, as you are aware the contract does commit some future unknown reserves. In light of the risks that we understand (indisc.) ALPETCO and the State of Alaska will be taking should it go ahead with the project, can you comment on the (indisc. - cough) that the State might have in committing those unknown reserves, the non-Prudhoe reserves?

MR. LIPTON:

Insofar as there is a question whether you will have adequate royalty oil out of Prudhoe over the duration of this contract, whether it's this contract or any other contract, if, in fact, it's the assured availability which offsets the known disadvantages, then nothing's going to fly unless you're prepared to commit the hundred of a hundred and twenty-five of a hundred and fifty. Which means also the right of first refusal over any deficiency out of the royalty oil from Prudhoe out of other royalty oil anywhere else in the state. That is, whether it's this particular project, or whether you say no to this, and Dow Chemical comes back three years from now. If you're going to offset competitive disadvantages by assured availability, you've got to assure availability.

Is there a risk in this? Sure, this is another one of the risks. And the risk is that, in effect, you are committing this oil to a particular project under specified contractual price arrangements, which may by 1988 or 1989, 1990, or 1992 look to be far more attractive than other alternative in uses. It is difficult to say. And again, all . . . I think if you want this kind of a project, whether it's this group or another group, you're going to have to give assurance of supply. It's a risk you take. I don't know how high I would count that risk. I think, in many respects, the contract is as carefully worded as it can be to minimize the State's risk. I mean, you're not going to get any bargains on the royalty oil, although in the light of unknown circumstances it may be that they will still be able to get it at a price for their facility, which is less than what the State might otherwise later on may have been able to negotiate.

CHAIRMAN MILES:

Let's talk about pricing for just a bit. When you've come down and talked to us before, you have explained your theory about the, and I can remember you doing it, . . . the surpluses like this now, when it's going to be like this a little bit later on, and it was the availability versus the price, and you really didn't, we didn't have a contract before us. Can you comment on that theory insofar as this contract is concerned?

MR. LIPTON:

Oh, I still think it's the case. This group. . . again, I think imaginatively has foreseen what the world is going to look like in '85, '89, and '90, '95. Which means they are presuming they can take your royalty oil today, within twenty-four hours construct a facility, and sell the products in a world in which petrochemical capacity is way at surplus. So, therefore, seeing the time when, one, there will be less surplus capacity in the

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chemical industry, a greater demand from products from new facilities at a time when the new facility, which has assured access, has got a leg up over a new facility that doesn't have assured access. So, they're willing to take their chances on the price equation because they think that this is So, they are looking very, very far ahead.

I guess what I said to you last time that the way in which corporations react to this future, and virtually everybody sees the future the same way. They have different years that they put onto it. The C.I.A. says a catastrophe by 1982- - - we're all going to run short of oil. The O.E.C.D. says well, by 1988 - '89 it's going to be tight, but there's going to be enough oil left. Everybody sees the due date as somewhat different, but everybody sees the probability of a tighter supply situation in the world of oil than (indisc.) is today even if there aren't acute shortages.

Now, when investment decisions are made with a sense of urgency, or when prices start getting bid up, doesn't depend upon the shortage being there. It depends upon how soon companies begin to see the shortage within their planning periods. If you've got a five-year planning period, and you see the shortage coming up within five years, well, that's at hand. So, what we're talking about is not shortages in the early 1980's but when companies will have to make investment decisions and begin to say, we'd better start worrying about what our position is going to be within the period of time that we make capital commitments for capacity. And there are very few that are doing it today. The ALPETCO group is saying that, essentially. I believe so. What they are saying is, we're not building for today's chemical market, we're building for tomorrow's chemical market. And, if we've got this thing timed right, we come on-stream at the right time. And they are saying it.

But, you know, none of us know when year "x" is going to come, and you are being asked to make a decision on the same basis as the ALPETCO group has made their decision. That is to say, make your commitments now well in anticipation for a facility which will come on-stream when '83, '84, '85, at the best, and will run for about twenty-seven years more. Than whether that's the best time to make that decision, it's hard to say. And, if you're convinced that you have a limited amount of royalty oil with which you would like to achieve a purpose, and if you don't do it within this year, or at least a couple of years, you may not have the same oil to bargain with. Then, perhaps the time is now.

CHAIRMAN MILES:

What you're saying is that we are at a very similar investment decision crossroads that ALPETCO or anybody else is.

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MR. LIPTON:

Absolutely.

CHAIRMAN MILES:

And we have to make a decision if the time is right for us to invest.

MR. LIPTON:

Sure. And, truly, if you want a facility which has to depend upon assured availability, and you think that all you've got is 12 1/2 percent of something under ten billion dollars at Prudhoe, and you've got to strike your bargain with that before too much of that runs out, then you don't have that much time. If you think that you've got a future here in Alaska, and it's not just Prudhoe Bay, but a lot of other things coming on, then the cost of waiting is perhaps not that great.

MR. OSTERBACK:

Is there anything else they could do with this crude oil? Would it be feasible for putting in a plant for rope and (indisc.)?

MR. LIPTON:

For what? I'm sorry.

MR. OSTERBACK:

For rope. You know, like nylon rope, poly-rope, web . . . Has anybody ever talked about that? The price has been doubling on that.

MR. LIPTON:

Not that I'm aware of, but if you have an aromatics plant, you've got the basis of nylon. Now how far you go. . . You know what the problem in Alaska is? That the closer. . . you have a very limited market here, a very limited market, so the more you go into finished products, you know. . . . To satisfy the Alaskan market is really the best thing that could happen to Alaska. Whether it's nylon rope or garbage bags, or almost anything which is petrochemical-based. This becomes a tremendous advantage for Alaska, because otherwise you ship out and you ship back and forth, but there is a real problem involved - how far you can push the downstream processing into finished products.

MR. OSTERBACK:

I'm not talking about shipping, but most of our rope now comes from Japan, Norway, Sweden, and that's a hell of a lot further than Alaska, if you're talking about shipping down to Washington, Oregon, and California. It's a lot closer.

I mean, I was just asking if that would be feasible to put these plants up.

MR. LIPTON:

I don't know. From the standpoint of any group itself insofar as they can satisfy the Japanese market, if they can satisfy the Alaskan market, which otherwise is served from Japan, it's all to their advantage. It's all to their. . . The question comes down to scale and how they are going to put it all together. I really don't know.

MR. OSTERBACK:

Thank you, Mr. Chairman.

SENATOR HACKNEY:

Mr. Lipton, the prospect of not having to make a decision is always something that is dear to a Legislator's heart. Did I understand you to say that the sky would not fall if we were not to accept this contract and were to wait say, a year, two years? And, if we were to wait, how long should we wait?

MR. LIPTON:

With a certain amount of confidence, I will answer, the sky will not fall. Now that I answer the other part of your question, I have more difficulty. But, really, what is now being proposed? The sense of urgency is because of the availability of the oil. If you don't commit it, then whoever wants to put together a project has more and more difficulty of telling his customers and his financiers that the one thing I've got that other people don't have is the short availability. 'Cause the further you postpone it, the less assurance there is of availability, unless, come '79 and an open-lease sale and some successful drilling, and then everything gets turned all around.

But, I would think that a year or two is not going to be tragic for Alaska, except that, in a sense, what you're saying is we are turning our back on what has come to us in good faith, because we are hoping for something more. I would. . . This has to do with the psychological. But, the companies who might otherwise be involved with the ALPETCO group are not going to disappear in a year or two. They are still going to be there for ALPETCO or anybody else, or maybe come in as a party of the first part. I don't know, and I certainly don't hold this out as something of great promise.

I really don't think that . . . It's one set of uncertainties against the other. There are risks in this; there are uncertainties if you say no. At least what you've got here is certainly a promise of sincere and major effort. I think that that's about the best that I could. . . There are uncertainties all over the place for them, for the State of Alaska.

CHAIRMAN MILES:

Can I follow up on that, Senator Hackney, if I may?

If the risks are there, I suspect similar risks will be there in a year or two. But, don't we come down to a situation where the oil becomes more valuable to the State of Alaska and, therefore, to any potential purchasers in a year or in two years?

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MR. LIPTON:

Well, I think that out of a combination of world developments and U. S. policy, your oil will become more valuable. It will become more valuable as royalty oil and it will become more valuable for whatever purpose. The only question is whether you have dissipated a sufficient quantity of the Prudhoe Bay reserves and what you have left is royalty oil, looks to be less and less sufficient as the basis for a short availability. One can't turn his back on that. If it's assured availability that's going to overcome competitive disadvantages, then the longer you hold out the less you have to offer as assured availability and the more it becomes speculative. The next time around, and the third time around, and the fourth time around you would have to offer an option on what comes up.

The other things come through relatively quickly, you're in great shape. Absolutely in great shape. I would say that if there were another major discovery in Alaska, so that you see your future further down the road than you do today, then you will have lost nothing. Except you will have lost the effort of a very determined group that are pushing like all hell, and that doesn't (indisc.).

MR. CHATTERTON:

Thank you, Mr. Chairman.

Mr. Lipton, I've been trying to figure out how to get to this question. I think I finally may have. If you were a party, the buyer party, to the contract as you have seen and probably understand, and everything in that contract remained constant, but gave you one option not in that contract now. . . say we could give you this option. . . to locate this complex that you are going to build in Valdez or someplace on the West Coast of the contiguous "forty-eight", what would be your choice?

MR. LIPTON:

The West Coast, beyond any doubt. If you had the same assured access to Alaska's royalty crude for a project on the West Coast, I don't think anybody would consider Alaska.

It's not a natural location for a petrochemical facility, anymore than Puerto Rico is.

MR. CHATTERTON:

If I heard the testimony on the last couple of days correctly and the answers to questions correctly, I think that the solitary, single big apple is the (indisc.) one that you mentioned, and I think that ALPETCO fully recognizes, and this is the long-term twenty-seven-year (indisc. - cough).

MR. LIPTON:

Of course, of course. Surely, surely.

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MR. CHATTERTON:

And if we could keep the same supply, if we could lock it up right, or we could replenish it from new discoveries, would not a person be willing to make even greater sacrifices as the buyer may possibly be willing to make greater sacrifices in years from now than you are today, with the same guarantee....

MR. LIPTON:

Well, I think that, if you are right in our perception of the future, the closer we come to the time when the buyer sees close at hand the tightness, the more valuable assured access becomes. Yes. In the same sense that the parties that are negotiating in the Middle East today, on both sides of the fence, are rather prepared to drag the thing out and let it go, so, instead of coming onstream in 1981, it comes onstream in 1984 or 1986. There is no sense of urgency if they can keep negotiating, but get the thing going at a time when it's closer to when everything looks to be relatively more assured than at the present time. I think that's right.

MR. CHATTERTON:

Anyone in our case, with the contract we have, anything we can do to, and I can't remember the terms of the contract so this may be in order, but, if it's possible, why we would....you as the (indisc.) would certainly be interested in trying to extend so far as possible into the future the date that triggers off the twenty-seven-year period. And it may be the contract starts....

MR. LIPTON:

I'm talking now as a buyer, not as an investor. But it depends upon the buyer's circumstances. He has his own conception of when he needs products for further processing for integration into his markets. And, if he foresees that he is going to need new capacity either by construction or by purchase for 1983, he would just as soon start a contract in 1983. But given the way the surpluses are going, if you want to generalize, I would say, yes, you're better off later down than line than earlier.

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

MR. MCKINNON:

Mr. Lipton, to what extent does Article 2.3 preclude any other in-state use of royalty oil? It's the article that gives up ALPETCO's first option.

MR. LIPTON:

Yes.

MR. MCKINNON:

Another (indisc.)

MR. LIPTON:

As I read the.... As I read Article 2.3, this, in a sense, gives the group the right of first refusal over other oil insofar as is necessary to make up any deficiency out of Prudhoe. They are not entitled to more than 150,000 barrels a day. So, it depends on what your total volume of oil.... it doesn't preclude other sales necessarily, but it gives them, you know, the right of first refusal.

MR. MCKINNON:

Is that only for a deficiency out of Prudhoe?

MR. LIPTON:

I think so. Either a deficiency or, in the context of the other articles, if the other oil is priced lower in royalty value, then they substitute royalty oil from Prudhoe.

(indisc.), do you read that....?

MR. MCKINNON:

Yes, that's the way I interpret it.

MR. LIPTON:

This is the way that I interpret it. But, basically, the state is not committing more than 150,000 barrels of oil a day.

MR. MCKINNON:

It's my understanding that the provision, assuming that ALPETCO was taking out 150,000 barrels a day, well, say, 100,00 barrels (indisc.) at a cheaper price, that ALPETCO would have the option of replacing 100,000 barrels of their 150,000 (indisc.) under Prudhoe, with the other 100,000 being offered at a cheaper price.

MR. LIPTON:

I think that's right. They may have the right to substitute. But, in toto, not more than 150,000 barrels a day.

MR. MCKINNON:

To what extent does that serve to extend this contract beyond its twenty-seven year deadline?

MR. LIPTON:

I don't believe it does.

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MR. MCKINNON:

Well, the provision is that they all shall be offered to the buyer at the same price on the same terms and conditions as offered to third parties. Twenty years into this contract, the State makes an offer at a certain price with a twenty-year term....does that mean that ALPETCO gets the option to....

MR. LIPTON:

I would assume not. But, look, this is a legal interpretation of the contract. I would think that any reasonable man, which means not necessarily and attorney, would interpret this to mean the right to lift the twenty-seven year duration of the contract, and not because there is an offer of royalty oil elsewhere which may be available in the twentieth year of the contract, then for fifteen years they would have the right to extend it.

But, this is a legal interpretation of the contract. I would certainly not think that this is the intention of the drafters, either way.

MR. MCKINNON:

I didn't think it was, but I'm certain that it may have that effect.

MR. LIPTON:

Yes.

CHAIRMAN MILES:

Mr. Lipton, you mentioned before, and again tonight, that in any project of this particular nature the first five years may be rocky from a financial standpoint. They may be fairly tough.

MR. LIPTON:

Well, not necessarily. I mean there are capacities that come on-stream that are just at the right time of the cycle, and the first five years are magnificent. It's just that, again, I'm not making this as a prediction, I'm saying this is what the risk is for Alaska. But, if it works out that way, then it's a risk.

CHAIRMAN MILES:

I know you're not making that as a prediction, but you indicated that is a possibility and you use a five-year term (indisc.). When exactly does that five-year rough period begin? Does it begin after Legislative approval?

MR. LIPTON:

No, no. The five years I'm concerned about is the five years after coming on-stream, after starting. Because this is the time when all of the work has been done, the capital has been invested, when the contracts are beginning to be supplied. And then when you're worried about do you have

the volume to get optimum utilization of your capacity and, therefore, relatively low unit costs so you're getting the prices you had anticipated. And, in the first five or six years, at the start of an operation like this, the cash flow can be decisive for the survival of an operation.

MR. PARR:

Mr. Lipton, I'd like to make some rather flat statements in coming back to things that have been (indisc.) before (indisc.) things that I've understood from you cannot, as near as possible, get yes or no answers (indisc.). If I understood you correctly, one of the risks to the State is that this refinery, or this petrochemical plant, may have difficulties somewhere along, (indisc.). And the State is going to have to wind up getting to bail it out by going in and putting in equity into the petrochemical plant.

MR. LIPTON:

No, I didn't say putting in equity. I thought maybe modify the price at which the royalty oil is being delivered to enable them to survive in the face of a difficult cash (indisc.).

MR. PARR:

I thought that you had said both of those. I misunderstood you, then....only the one of having to lower the price of the feed-stock....that's the only one.

MR. LIPTON:

That's the most immediate one that occurs to me.

MR. PARR:

Looking ahead to 1983 or '84, or whenever (indisc. - cough), in petrochemicals, we are looking at a seller's market rather than a buyer's?

MR. LIPTON:

I'm not at all sure of that. Not at all convinced.

I know why. Because what you have is a projection of chemical demand, and, if you're projecting demand at six or seven percent, which is sometimes done, then what you speculate is that it needs so much capacity and, if it isn't forthcoming, you've got a seller's market. But turn it around. Let the expectation of a lot of companies in the chemical industry bid the demand goes up six or seven percent, and let demand go up four or five percent. The expectation of a six - seven percent growth means a lot of investment capacity. And the growth of four or five percent means you've got a buyer's market, not a seller's market.

It's very.... You know, the chemical industry, among others, goes through fantastic swings. And one of the reasons that it does - one - not all of the reasons it does, is that you tend to have a lot of companies make simultaneous investment on the basis of the same expectation. And, if enough of them expect the same thing to happen, then all of them become frustrated because the capacity goes in.

MR. PARR:

Has that resulted in, let's say, petrochemical plants being built in bunches and skipping a number of years and being built in another bunch?

MR. LIPTON:

They tended to be, yes. Very definitely.

MR. PARR:

Everybody has seen the possibility all at once?

MR. LIPTON:

Pretty much so. There's a lot of that. There's a great deal of that. It's not.... As I said, that's one factor - far and away from the whole story. A lot of it has got to do with when oil companies went into the chemical industry and why they did and under what circumstances, and changes in technology. A lot of these things happen.

But, certainly, one of them is that, if you've got a competitive industry that sees things through the same set of glasses.

MR. PARR:

Another thing we've been told and, again, I'm using my own words, which may not be exactly the words that were used, but is it because of the imbalance in trade between Japan and the United States and the strong economic pressures that make Japan interested in taking a U. S. export of this sort? Now the question of the dollar and the yen thing didn't even come into this, this was even disregarding the dollar and the yen....

MR. LIPTON:

Yeah, sure, but there are a lot of ways Japan can do it. One way is to buy petrochemicals from Alaska, another way is to build automobile factories in the United States.

MR. PARR:

I didn't say, necessarily, in this particular instance....

MR. LIPTON:

I think it's a factor, but with all of the direction you have over industry from government in Japan, there's a limit to the extent to which public policy is going to lose to uneconomical commercial decisions.

MR. PARR:

I had gotten the impression from the testimony we had before that it's not such a marriage between government and big business in Japan, but it is a Siamese twin relationship. Which means that political decisions might well govern.

MR. LIPTON:

Well, maybe commercial decisions and government-political decisions?

MR. PARR:

Possibly.

Thank you, Mr. Chairman.

MR. LIPTON:

Excuse me, can I just expand on that for a moment?

The Japanese have always been interested in security of supply, and that's a combination of commercial and political decisions. And Japan has looked at Canada many times, under many different circumstances as a potential secure source of petroleum. Not necessarily to export to Japan because, come an emergency, they're not likely to, but if they have their own position, it becomes the basis for an exchange, or international balance of oil flows may be affected by their position. And there's no question but that it is widely believed, and the Japanese have held it out, that they will pay premiums for security of supply.

But, when it comes down to it, we've been involved in several of these projects. They will. But, the amount of premium that they are prepared to pay for security of supply is within manageable commercial limits. There is a limit to what they will do for it. And this had to do with the question of the Japanese investment in the (indisc.), that's all. All right?

CHAIRMAN MILES:

I'd like for you to go back over the industrial profile of the point that you made with respect to Saudi Arabia. I think I understand the situation on the West Coast and what large producers' situation is. I didn't fully understand the industrial

profile point that you made.

MR. LIPTON:

On the petrochemical investment there?

CHAIRMAN MILES:

Right. Insofar as it may, or may not, relate to Japan and the other Pacific (indisc.).

MR. LIPTON:

First, let me start with the competitive disadvantages of a petrochemical facility in Saudi Arabia, which are very similar to the problem of Alaska. One is that construction costs and capital requirements are very, very high. Secondly, your market is a distant market. Therefore, if you have to move your chemical products to the market, it costs more to move the chemical products to the market than to move the feedstock embodied in the crude oil. So, you're bucking up against a transportation disadvantage.

Now, the starting point to overcome that is, particularly in Saudi Arabia, is the availability of huge quantities of ethane, associated with their whole gas-gathering system, all of which they've been flaring gas at a fantastic rate. Now, if you look realistically at a world-scale ethane and ethylene-related operations in Saudi Arabia, and try to calculate at what price the ethane would have to go into an ethylene operation in order that the combination of feedstock cost, capital cost, and transportation cost would allow you to sell competitively in Europe or Japan, you come up almost inevitably with negative prices on the ethane. In other words, the Saudi Arabian government would have to supply the ethane at zero price and maybe pay to take the ethane. But the Saudi Arabs, from the very beginning, negotiated not in simplistic terms. They were talking in terms of a combination of operations in which the ethylene project would be jointly owned, they would put capital into it, your derivatives would have a different financial structure. And, in fact, if you put together everything, which is a very low price on the ethane, and a very, very low price on the capital, which the Saudi Arabs would largely provide, you'd begin to get close, maybe, to a competitive situation. But, probably not. I doubt very much if, at least what we have seen, anybody would voluntarily move into Saudi Arabia and, even on that basis, just build a plant.

But what they have to offer in addition to that, and they've held this out since 1975, not in 1974 - in 1974 everybody was coming to Saudi Arabia and begging them - and by 1975 they were asking Saudi Arabia, if you want to marry us, what kind of a dowry do you have? You know, the things had turned around by then. Well what they have to offer is this. Look, if you won't do this on the terms and circumstances which we will

together negotiate. In addition, the way we sweeten the whole investment project is by making available to you, not as feedstock to the project but for export purposes, for a given amount of capital investment, say a hundred thousand barrels a day of crude. Now, the further you push this project down the road, if it comes on-stream in 1985, you still may be in a difficult chemical environment. But, sooner or later, the project will pay out. But, meanwhile, if you can start gaining access to a hundred thousand barrels a day, a hundred-fifty thousand barrels of Saudi Arab crude, which is the most important and predictable source of world oil reserves for the long-run, over a period of time this becomes tremendously valuable. In the same sense, if you had said to a developer here in Alaska that we will sell you a hundred and fifty thousand barrels a day of royalty crude to do this investment, but, on top of that we will give you for export, beginning in 1990, another 50,000 barrels a day of Alaskan crude that you can do anything you want with, you've created an entirely different situation. This is what the Saudi Arabs are doing.

And this is why, what is essentially non-economic chemical capacity to a limited extent, and I don't think everything that's been booted about will not come to fruition, but I would guess three world-scale projects are reasonably well-assured at this date. It may come in largely because the Arabs have something else to offer, which is access to what will in the future be, scarce world oil reserves when the rest of the world is close to operating at productive capacity. The exspansible source of crude oil reserves production for the world will be Saudi Arabia.

CHAIRMAN MILES:

Let's just speak in terms of Japan now. From Japan's standpoint, would Japan rather have a source of Saudi Arabia or a source of Alaska?

MR. LIPTON:

Saudi Arabia. Saudi Arabia. You're talking about finite reserves here in Alaska. Unless, if things really work in exploration and turn Alaska into a fantastic producing province, is one thing, but we're worried about whether or not Prudhoe Bay will support twenty-seven years of a hundred-fifty thousand barrels a day (indisc.) crude. I'm not talking about Saudi Arabia producing a twenty million barrels a day, which was the expectation some years back, but whatever the demands upon Saudi Arabia, we are facing the year "x", and I don't know exactly when it is, when virtually most of the world will be operating at very close to capacity. And if the world is looking and saying, where will the next barrel of oil come from? - it will come from the reserves in Saudi Arabia.

And this is the most precious commodity they have, an expansible source of supply. It's not a bottomless barrel the way we thought in the 1950's, but it is, for the rest of the world, an expansible source of supply. And it becomes an extremely critical place for companies to go, and, if you'll notice, most of them go through Asia, which are going on into Saudi Arabia. They are companies that want either to improve or establish an off-take position in Saudi Arabia, which heretofore had been dominated by the members of ARAMCO (ph).

CHAIRMAN MILES:

I don't understand that. If we can assume for a moment we are talking about a hundred-and-fifty thousand barrels of oil from Alaska and a hundred-and-fifty thousand barrels from Saudi Arabia, I don't know if it's reasonable to make that kind of very narrow assumption. It would seem to me that, and again, relating to Japan, that they would rather have Alaskan source, if they could get the long-term commitment of.... mainly because of political stability.

MR. LIPTON:

I'm sorry, I misunderstood you.

If it's nothing more involved than an "x" number of barrels, and a price and competitive situation is about equal, they would rather have it Alaska, and they might even pay a premium... some premium for Alaska, but not very much. What I'm saying is it's not "x" barrels against "x" barrels. In Saudi Arabia it's "x" barrels plus. This is basically what they are getting in Saudi Arabia. They are establishing a position which gives them preferred access, not according to their feedstocks, but the off-take of crude oil for export purposes. This is the big thing. And in Iran, where so far the Shah has been unwilling to do this, the Japanese have been negotiating the petrochemical operation for years and years, and they haven't been coming anywhere on it. And only, I think, if they're going to be something which gives them more than just access to feedstock, because Iran is as unattractive a place to put export capacity and chemical industry as Alaska or Saudi Arabia. One doesn't go into these areas just on a purely commercial basis, I don't believe.

CHAIRMAN MILES:

Thank you.

MR. CHATTERTON:

Excepting the news of the last thirty-six hours or so, do you rate the "economic climate" in the Kingdom of Saudi Arabia any less stable than the economic climate in the State of Alaska?

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MR. LIPTON:

It's a damn sight less stable than the climate of Alaska. Sure. I mean, if you're assessing political risks, there's just no question about it. No question about it.

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

SENATOR HACKNEY:

Mr. Chairman, the only time I ever heard Mr. Lipton really put in a box was the time when somebody sat at a position just about like this and they said, "Mr. Lipton, if you were sitting in my seat in the Senate, and this (indisc.) before you at the present time, and you had a green button and you had a red button, which button would you push?"

MR. LIPTON:

Remember what I said?

SENATOR HACKNEY:

Yes, I do. Push the green button. Would you push to green button in this case?

MR. LIPTON:

I don't remember saying push the green button. I think what I said was, if you'll give me a vote on everything else you can vote on the Alaska Legislature, then I'll vote on that issue.

MR. PARR:

Mr. Lipton, what you said, in effect, I think, greatly oversimplified, is we accept this deal. It's a pretty good contract. The real thing is ALPETCO is taking some calculated risks, and they are using their best judgment in this area. And the State, of course, if we go over the contract, essentially takes the same kind of risks. And you have not said whether you think it's a good risk or not. Maybe it's not in your field, I don't know.

MR. LIPTON:

See, I can't say that without being a Legislator who weighs everything in the balance. That's the difficulty. I don't want to overplay the risks here. And I do think it's a contract which, under the circumstances, was started from very little interest from anywhere around. It represents a maximum effort

on the part the group, and it represents a maximum effort on the part of the people who drafted the contract to protect the State.

The question is, how do you assess the value of the whole thing? There are risks.

MR. PARR:

Nobody, who is very much interested in security, comes to Alaska in the first place. If they do, they don't stay. It isn't that kind of place. On the other hand, what I think most of us try to do is try to assess the risks as carefully as we can, and which, I think, is where we are hoping you can help us. If the gamble seems like a good gamble, we will go. If it's a poor gamble....

MR. LIPTON:

Let me try. You're asking me very straight-forward questions, and I try to give you straight-forward answers, but does it make my answers correct? Then I give you a judgment.

I think the biggest risk is that the contract will collapse, as we personally assess the probability of success as not all that great. And this is the risk. Now, what's the cost to Alaska if it does? That is, if an honest effort has been made and you've got this protection, and, whether it's eighteen months or twenty-four months, the ALPETCO group will be out a considerable amount of money. What has Alaska lost? It's a subtle thing. I guess you don't have the answer to that, but let me tell you the impression I have.

Alaska has been involved now in a series of episodes involving contracts with off-takers. And, first, it was on the joint resolution of the Legislature and then it was on the sale of the royalty gas - all for a specific purpose. Has Alaska suffered because of this? Well, at some point, if there is misadventure after misadventure, questions begin to arise about how solid is the thinking up there in Alaska about these things. If the contract doesn't come to fruition in the nineteen months or the twenty-four months, I don't think Alaska has lost a great deal. But, it's just become one more episode. But, I think that's about the greatest risk.

The other risk is that everything is going to go, and the investment's all going to be made, and it may lead to a very, very difficult time. And you may be faced with things which, under the contract, you do not anticipate; that is to say, a real sense of responsibility on the then-administration in the State of Alaska and the Legislature at that time that, hell, we can't let this go down the drain. Maybe that's not all so bad, because, if the thing does come to fruition - if

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you have to hold for five years or seven years - that's not in the contract, but that's a risk you may have to do this, and it may not even be all that bad.

But, if you're asking me honestly to give you a personal judgment, that we've all discussed, it seems this is the way we assess it. Now you've got to decide whether, if the worst of these come to fruition, how much does Alaska suffer by it? I can't answer that question, but this is about the way which we will try to evaluate. The biggest risk and the highest probability, I think, is that it will not come to pass. What does it cost you? You decide now.

The other risk is way down the road, and then you may face things that your successors will feel obligated to do, even though the contract doesn't call for it. They may not be so terrible, if worse comes to worse, and if it turns out to be only a short holding operation. But, these are risks.

CHAIRMAN MILES:

You're talking about another set of risks if everything goes, and then some new unforeseen, or heretofore undiscussed, problems (indisc.). What does.... Okay, what are some of those that you haven't yet discussed?

MR. LIPTON:

Well, look....that every step along the line the project looks like it's working out, then the fact you do have off-take contracts. And on the basis of the off-take contracts, commitments are made to finance, whether it's net capital or whether it's equity capital and joint ventures, but commitments are made, because everybody perceives step by step down the line that it's working out. And on that basis, ALPETCO has performed according to the due dates of the contract. But, then, about the time when.... While all of this is going on, other people are making their own investment decisions, too, in similar expectations, and it turns out that, when the first crude oil is being processed, and the first gas oil from the refinery is going into an ethylene operation, and naphtha is being cracked, and products are coming out, all of a sudden you don't have as firm volumes, which changes your average cost of processing, and the prices are somewhat lower than have been anticipated in all of the calculations, because nobody is committing you to a firm price in the future. You are going to have to meet competitive prices, whoever is doing this operation. This could put an on-going operation in a cash bind for some time. And that's not a matter of something unforeseen happening. Everybody who is looking at this is willing to acknowledge that this could happen. These are the

imponderables that happen in the world chemical industry. All I'm saying is that at that point the State of Alaska may be faced with commitments they feel obliged to undertake, which go beyond that of the contract, simply because this is one of your major investment projects in Alaska. And, one way or another, you are not going to allow it to founder for the lack of cash flow.

MR. CHATTERTON:

Then the obvious way to help it out is to reduce the cost of the feedstock.

MR. LIPTON:

Yes. Sure.

MR. CHATTERTON:

Thank you. Mr. Chairman, if I may continue....

This point that you raised earlier of petrochemical plants, etc., even product refineries, "they sort of come in bunches like grapes - they're all built".... The possibility that you pointed out of getting into a cash flow problem after this deal is on-stream, was it in the late fifties or early sixties where there was a situation - as far as I know in Canada and also (indisc.) - with the market for sulfur (indisc.) out of gas?

MR. LIPTON:

Oh, yes....the sulfur problem. Yes....sure. Just let me say this, too. It's not my purpose to put a dark light on this, because none of these things might happen. But, if you've gotten beyond what is the point of no return on the project, you can even, the ALPETCO people or anybody else, foresee problems ahead. But, once you've passed the point of no return, the work having been done, you don't stop the project. One goes ahead.

There is a point at which capital has been committed and construction is going that one goes ahead and completes the project. Look, I don't mean.... I know I sound like.... I don't mean to come here, you know, and preach Doomsday here. It could work out just the opposite way, but my responsibility is to the Legislature, and I feel one of the things I must do is discuss what the uncertainties and what the risks are.

MR. CHATTERTON:

Mr. Chairman, I guess it's just human nature, even though you see if by any chance things look rocky ahead, why you can proceed to build your mind up until you want that (indisc.) as large and as glistening as possible, because that may be the last way to do it right.

MR. LIPTON:

I wasn't really thinking of that. That's probable. But, what I was really thinking was that in an investment process the way in which you evaluate the profitability of an investment decision is always what is the incremental investment and what we will get back from that. And there comes a point when you've sunk so much money that it's not a matter of whether what you've already invested pays out, but it's the incremental investment, and what do we get in return for that.

Of course, the classic story of that, and forgive me for bringing a New York episode into it, but this goes back to the 1930's when one of our most famous public servants, Bob Moses, was at that time - later on he built everything - but, at that time, he was in charge of the New York State Recreation Department, and he decided to build Jones Beach, which has become a monument in due course. He asked for an appropriation for Jones Beach, and there was no way in which the state legislature was going to give him those funds. They gave him the funds which they thought were appropriate. And he took all those funds, and he built the foundation for Jones Beach. Then he said, "Now I've got the foundation - give me the rest of it." This is incremental investment decision-making.

UNIDENTIFIED SPEAKER:

The (indisc.) is alive and well and living in Alaska.

CHAIRMAN MILES:

Can you give us an over-view of how this decision, Mr. Lipton, might relate to the other decisions regarding financing of gas line, gas liquids, the structure in which we might be viewing those various decisions? As you know, we are being asked to participate in - the Northwest Gas Line - make a decision whether to (indisc.). Can you kind of give us your over-view?

MR. LIPTON:

I don't think that your decision on the royalty crude contract ought to be contingent upon what may, or may not, happen on the gas. I think that the probabilities of being able to use gas liquids as the basis for industrial development as an

alternative to this are really not much more exciting. I think probably they are more difficult. I think they are more difficult.

You've got a lot of problems on what you're going to do with your gas, when is it stripped, who's going to strip it, is it (indisc.). These are a lot of very difficult problems. They are too elusive right now to try to come to grips with all of them. I would say that we don't feel that your decision on the royalty crude contract now ought to be conditioned in the probability or improbability of what may happen to the gas liquids.

We have been very excited about what may be done with gas liquids. As you know, for many years we first talked about gas liquids probably being of greater significance to Alaska, per se, than the natural gas itself. It's not as though you are going to be energy-short in Alaska. But when you start looking at the specifics of it and, even what we have mentioned on several occasions, which is thinking small instead of big at Fairbanks, there are a hell of a lot of problems that show up. Now, things may still be done, and there are a lot of permutations and combinations, but I think you would be ill-advised at this stage of the legislative process, or the royalty disposition process, to try to condition your decision on this project in terms of what may, or may not, be done with natural gas.

CHAIRMAN MILES:

Thank you. Mr. Lipton, thank you very much. Do you have any closing remarks?

MR. LIPTON:

No, except to express my appreciation for the courtesy you have extended, and I have enjoyed this conversation very much.

CHAIRMAN MILES:

Thank you very much.

Shall we adjourn until tomorrow night - same time, same place?

SCOMM

#14:10



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Alaska State Legislature

TRANSCRIPT OF TESTIMONY OF

PUBLIC REBUTTAL

March 18, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:

Representatives:
Chairman Bill Miles
Al Osterback
Chat Chatterton
Mike Miller

CHAIRMAN MILES:

Okay. We'll call this meeting of the House Special Royalty Oil and Gas meeting to order. I'd like to welcome the people here in Juneau.

At the Committee table we have Vice Chairman of the Committee, Representative Al Osterback, Representative Chat Chatterton, Representative Mike Miller, House Majority Leader, and myself, Bill Miles, Chairman of the Committee.

Very briefly, I'd like to explain to the people in Juneau that we are tele-conferencing this hearing. What that, in essence, does is make the comments from the witnesses and from the Committee members available live and direct to Anchorage, Fairbanks, and Nome. We have similar electronic networks set up to both listen and speak in those areas.

The procedure that will follow today in this tele-conferencing hearing is we will take testimony from the witnesses in Juneau... all the witnesses who desire to make a statement for the benefit of those in Anchorage, Fairbanks, and Nome. I doesn't look like we're going to have too many witnesses. Then we'll go on equal footing into Nome, Fairbanks, and Anchorage taking one witness from each area.

Perhaps, for the benefit of the people on the other end of these microphones, I'll give just a short recap of what the Committee's done this week. On Monday we held a joint hearing with the Senate Oil and Gas Committee, and the principal witnesses were the ladies and gentlemen representing ALPETCO, the firm with whom the state has a tentative commitment for the sale of royalty oil. On Tuesday we had Commissioner Robert LeResche, the Chief Negotiator for the state, outline his views of the historical aspects of the contract and answer a number of questions relating to certain aspects of the contract. On Wednesday a Legislative Consultant, Milton Lipton, who is Vice President of Walter Levy (indisc.) & Associates, spent the evening with us discussing various aspects of world, national, and state economy, if you like to call it that... and again answering questions about the specific contract and the concept of the proposed contract. Thursday evening we had a marathon session that lasted from seven until eleven in the evening with Legislative Consultants from Battelle Northwest who discussed the issue of the state taking its royalty oil in kind as opposed to the state taking its royalty oil in value. Following Mr. Swift and Mr. Clummett (indisc.) from Battelle, we had Dr. Arlon Tussing, of the University of Alaska, speak to a number of issues related to the sale of royalty oil.

That essentially brings us to today's hearing because, in our unusual wisdom, we decided to take St. Patrick's night off, and I'd like to clear with Anchorage and Fairbanks that I went to bed at eight o'clock. It was a very disappointing St. Patrick's night for me.

Subsequent to this hearing, we intend to go through the specific contractual provisions with the representatives from the Department of Natural Resources, the state's negotiator, as well as representatives from ALPETCO. We also have two outstanding studies that will, hopefully, be in the first part of April. We have (indisc.) specific questions relating to the contract to Battelle Northwest. Additionally, we have a net benefit study in progress by I.S.E.R. at the University of Alaska. Following this week of hearings, we are going to address specific questions, further specific questions, to the principals, both the Department of Natural Resources and the representatives from ALPETCO. Hopefully, we'll be able to get a response within seven to ten days and accumulate all the existing information plus the responses to these questions and the outstanding study and make a decision one way or another on the contract.

One final point before we turn the microphone over to our first witness in Juneau, is, for the record, Dr. Tussing requested that his statement before the Royalty Oil and Gas Advisory Board be included in the record that has been distributed to Committee members and is in the record. Additionally, statements from a Wilson A. Rice and Matthew Berman, Trustees of Alaska and Anchorage,

will be included in the formal record of the hearing. With that in mind, we'll turn the microphone and the floor over to Mr. Honig, Chairman of ALPETCO. Mr. Honig.

MR. HONIG:

Thank you, Mr. Chairman.

Representatives Osterback, Chatterton, and Miller, we appreciate the opportunity of appearing before you again after you've conducted a long week of hearings on the Alaska Petrochemical Company project and its proposal to build a petrochemical facility in Alaska to process Alaska royalty oil.

Most of the testimony we've heard this week addressed the risks involved and the rewards for taking those risks and whether the ALPETCO proposal involves any state subsidy or not. I'd like to address these three subjects briefly in rebuttal, and these subjects are the risks, the rewards, and the subsidies.

First, let's look at the subsidies. One newspaper account said the contract includes provisions for both direct and indirect subsidies for the plant. It said that any direct subsidy in the form of a negotiated reduction in price of oil would have to be approved by the voters. But it said the contract also gives ALPETCO an option on seventy percent of any future royalty oil which might be sold cheaper than Prudhoe Bay oil. These are misleading statements in our opinion. ALPETCO's right to up to seventy percent of other royalty oil is neither a subsidy nor does it give ALPETCO a veto on future competition, as has also been said. This Section 2.3 of the contract merely prevents the state, in the future, from engaging in unfair competition. Once ALPETCO's plant is running, if the state should then decide to sell royalty crude oil to someone else at a lower price than we are bound to pay under the contract, then we have the right to that same lower price for that quantity being offered at a lower price than ours. This is only fair, and it's a customary provision in long-term supply contracts.

Regarding the other so-called direct subsidy, the contract makes it as hard as is possible for ALPETCO to ever reduce the price it will pay the state for the royalty crude. Any reduction of the price provision must be approved first by the Administration, second by the Legislature, and, finally, by a vote of all the voters. I fail to see how either of these provisions can be referred to as subsidies.

As Milton Lipton told you, nothing will fly without a firm quantity. The contract must assure availability, he said. Regarding the contract generally, Mr. Lipton also said it was "carefully drawn, imaginative, and favorable to the state." He told the Committee that it represents maximum effort on the part of ALPETCO and the state. ALPETCO is getting no bargain, he said.

Secondly, a lot has been said this week about risks to the state,

and less has been said about the rewards to the state. Most things in life involve some risks, in the broader sense, and usually we face some trade-off between risk and reward. It would have been safer to have stayed home this morning, but we took the risk of leaving so we could be rewarded with each other's company.

Let's divide risks and rewards into near-term, say the next five years, and long-term, beyond five years. Near-term to risks have been discussed by your consultants. One felt that ALPETCO might flood the California market with crude oil, undercut prices for the oil, and thus lower the average value that Alaska would receive for its royalty oil and severance tax. This scenario, we feel, is extremely remote. ALPETCO cannot take any crude at all on an interim basis until it has long-term financing commitment for a least one-and-a-half billion dollars and it has at least seventy percent of the plant output under long-term contracts before we can take any crude on an interim basis.

Besides, ALPETCO cannot borrow money to finance interim crude purchases from our banks unless it is already under contract for sale and for sale at a profit. So, it's difficult to see how this is probable at all. The only other near-term risk I recall being mentioned is that ALPETCO might be unable to put the project together within the next eighteen months. This is certainly possible. We cannot guarantee the project will fly, but we're betting several years of effort and at least ten million dollars that it will fly in that eighteen-month period. Suppose it doesn't. On the down side, maybe two years have gone by and Alaska is still without a plant. There is no project, but the state still has its oil and it has spent no money. Where is the risk, then, except for ALPETCO's loss? Some of your consultants have said such a two-year delay might be a plus for the state. The markets may be better by then. So, there's no risk here for the State of Alaska.

On the other hand, what are the near-term rewards? There are two big ones. One is employment and the other is contracting work for Alaskans. During the five-year construction period it is estimated that the construction jobs in Alaska will approximate four thousand employees. The total construction man hours in Alaska is estimated by engineers by over thirty-four million man hours spent in Alaska. Additionally, ALPETCO will make the maximum use of local sub-contracting and local supply firms. Add to these the support jobs and the indirect services, and the near-term rewards are immense.

But the long-term risks and the long-term rewards are the most important. What are these? The worst long-term risk mentioned by your consultants is that the plant will be built and running, perhaps for several years, the one-and-a-half to two-and-a-half billion dollars will have been invested, and then the economy sours, or the petrochemical industry sags, or the big companies somehow squeeze

ALPETCO so that ALPETCO starts losing money and has to shut the plant down. This could happen. It's possible. It can happen no matter how big the company is that owns a petrochemical plant or any other kind of plant, for that matter. But this is not a function of the contract plans proposed. It is a fact of life; a risk we take in pursuit of greater rewards. It's not too probable in ALPETCO's case that that will happen, because for ALPETCO to get financing, it must prove to the lenders that this risk is minimal. But, suppose the completed petrochemical plant does fall on hard times. The State of Alaska takes back its crude oil, in that event. It does not have to give ALPETCO anything. It does not have to lower the price on the oil.... that's up to you. If bad times occur, then at that time, not now, you, the Legislature, the administrative part of the government, must make a decision. Do nothing, and get your oil back, or work with a new owner to operate the plant. But, if you want to lower the price; that is, pay for the crude, then the voters must also approve it after you have approved it. Whatever the risk is to ALPETCO, ALPETCO is willing to take it. We're not newcomers to Alaska. We've taken risks in Alaska before, because we believed in the future of the State.

In 1959 we took a risk in Alaska. We invested sixteen million dollars. It doesn't sound like much today, but it was an awful lot...amount of money then. We invested it in a natural gas pipeline distribution system for Anchorage. This was long before Prudhoe Bay, long before high fuel prices. That project...that investment was so risky that in order to borrow the money we had to get the oil companies who were willing to sell us the gas to co-sign our notes. We didn't have any customers at all to begin with. But, we had faith in the growth of Alaska. We had faith in that project. We took a risk, and we've enjoyed the reward... so have the people of Anchorage and so have the people of Alaska.

This contract is a good contract for Alaskans. It creates permanent jobs...almost three thousand permanent jobs. It creates a large, additional tax base; approximately forty-nine million a year in today's dollars. It creates an investment for almost thirty-five thousand Alaskans to participate in the affairs and the profits of the company. It also provides profits to be shared in an endowment trust for the benefit of Alaska. As Mr. Lipton said, if it comes to fruition, this project has many advantages to the State. Even Arnold Tussing said, it will benefit Alaska if ALPETCO can put it all together. What we ask of you is the opportunity to try. Thank you, Mr. Chairman.

CHAIRMAN MILES:

Thank you very much, Mr. Honig. Questions from the Committee?

I have a comment on the point about subsidy, and we seem to have

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gone 'round and 'round on this before. You stated that this is neither a subsidy nor a veto over future contracts, or words to that (indisc.). I still have a tendency to disagree with you on that. There are clauses in the contract which state that we have to build a (indisc.) tank. I think that one of your consultants priced that at roughly at nine million dollars, and it won't get paid for that until the termination of the contract twenty-seven years down the pike. To me that appears to be a subsidy.

Additionally, there is a specific clause in the contract, and I believe you referred to it, about the...if there is a price change, the Administration, the Legislators, and the voters have to ratify that. Well, the very existence of that clause indicates that in the future there may be a request for a less than in-value price change or reduction of price change. I think we've both discussed this. I'd just like to have those comments on the record, and you are certainly free to respond, Mr. Honig, but....

MR. HONIG:

I'd like to make a comment on each of them, if I may.

CHAIRMAN MILES:

Certainly, Sir.

MR. HONIG:

With respect to (indisc.), I suppose that could be viewed as a subsidy. Actually, the agreement provides that we will repay the State the value of that pack at the end of the contract and at end-of-contract values on crude. So, I really think it's more of an investment of nine million dollars, if you want to look at it that way, than it is anything else.

CHAIRMAN MILES:

Well, you could look at it that way or as a subsidy for twenty-seven years.

MR. HONIG:

Yes, I suppose you can look at it either way. It was considered I think by most as one of the nits in the many, many months of negotiation. It is a lot of money, but it is not a lot of money relative to the amounts we are talking about in the contract.

On the second point about the provision in the contract that any price change must also be...any lowering of price must be voted on by the voters, as you've been told, I believe, earlier this week this provision was insisted on by the Governor, and I think it is significant because, if there were no such provision at all

in the contract, if the contract were silent on any provision of price, then, as we all know, ALPETCO and the Administration and the Legislature could agree on any term outside of the contract by mutual consent and could modify the contract by mutual consent without every going to the public for a vote. So, the fact that the clause is in there certainly doesn't weaken the contract. It simply says that ALPETCO and the Administration and the Legislature cannot get together and agree on a price reduction unless and until the people vote on it and also approve it. So, I think it's a strength and not a weakness because, as I said, absent that provision, it would be easier to modify the price downward.

CHAIRMAN MILES:

My point in raising the voter approval is not to say whether it's a good idea or a bad idea, it's just to make very clear that the parties to the negotiation, the Administration and ALPETCO, were cognizant to the fact that this request for price reduction is an important part of the contract and that they were very aware of it and that it's a very real possibility. That's the point that I would like to make.

Questions from the...Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman.

Mr. Honig, I have in front of me here what is numbered page five of the flash cards that you presented the middle of last week in your direct testimony in support of this deal. The title of it is No Risk to Alaska Performance Bench Marks. I have, since that time, gone through the contract sort of very rapidly, and I could not find there...and I wondered, with reference to that list, at what bench mark, in time, or performance, or commitment do you earn the right to take all or part of the state's royalty oil. When do you qualify to do that?

MR. HONIG:

We qualify to do that after we have obtained a permanent financing commitment for at least one-and-a-half billion dollars. And we cannot take any oil from the state until we have obtained that commitment, written commitment for financing, and have furnished the state with a copy of that commitment.

MR. PRATT:

Mr. Chatterton, specific reference is made to Article 10.2, subsection D...it's on page 32 of the contract.

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MR. CHATTERTON:

All right. As I have said, I have gone through this and I could not see in Article 10.2, subsection D, A, B, C, or on, up through H.

MR. PRATT:

All right. May I take you to page 6? Mr. Chairman, I'm Henry Pratt, for the record...also with ALPETCO. Article 2.2, Initiation of First Delivery, the first sentence says...After the date Buyer has obtained the financing commitment referred to in Article 10.2(3)(d)... So, if you go back to 10.2(3)(d), that's within the eighteen months after the effective date, and (d) is obtain or cause contractually bound third parties to obtain written commitments to lend or invest at least one-and-a-half billion dollars.

MR. CHATTERTON:

In other words, all you have... If I understand, then, all you have to have is a showing that you have people willing to loan you up to 1.5 billion dollars. Is that right?

MR. HONIG:

That is correct; plus the things that would be necessitated in order to get such a written commitment. No lender is going to give a written commitment to lend us or anyone else that much money or less than that much money unless he's sure that he can be repaid, and unless he's as sure as he can be that he will be paid the interest as well as be repaid the principal. So, as we...as our bankers and investment bankers testified earlier this week, they are willing to commit the financing on this project provided we have it put together. And put together means provided we have, in addition to the long-term contract with the state, ratified by the Legislature, we must have contracts to sell the products over a long period of time in order for the lenders to be as sure as they can be that they will be repaid. So, when you get the financing commitment, it says a lot of things, and it provides a lot of security I would think for the state, because the lenders are pretty hard-boiled about lending money.

MR. CHATTERTON:

Mr. Chairman, if I may continue.

Thank you for that. I understand what you say, but you are under the understanding and the state is under the understanding that once you have the showing, the finance ability, the borrowing ability of one-and-a-half billion dollars, why you then have... and under the terms of the contract...the right to take all or

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part of 150 million...150 thousand barrels a day of royalty oil.
Is that correct?

MR. HONIG:

Not quite. I think that it's not only the borrowing capability but we must have a written commitment by lenders to lend us that money. Our capabilities could be one thing, but this requires a commitment that we could borrow the money for this project.

MR. CHATTERTON:

All right. You have here....let's go out here eighteen months into the future and you come to our Commissioner of Natural Resources, and there is the Melon or the Hunt Estate, or something like that, says yes; they are willing to proceed to loan you one-and-a-half billion dollars for the purpose of constructing a plant. Now you would say that the Commissioner would look at that and say, here is a bona fide offer to loan one-and-a-half billion dollars. Right?

MR. HONIG:

To build a plant...yes.

MR. CHATTERTON:

To build a plant.

MR. HONIG:

Right.

MR. CHATTERTON:

And, having made that choice with that instrument, you then would say the contract entitles you to start purchasing up to 150 thousand barrels a day of royalty oil. Right?

MR. HONIG:

Right.

MR. CHATTERTON:

Very good. Now, does that have any guarantee, that in itself, that you are ever going to build a plant?

MR. HONIG:

Yes, I think it does, because, like any contract, you can't read any one phrase out of context, and if we proceed with the bench marks, which you referred to, in the contract, and as outlined

on page 5 of the presentation to the Committee, at that same time, which eighteen months after the contract has been ratified by the Legislature, we must within the eighteen months not only get the financing commitment referred to but we must also have committed to spend ten million dollars, we must have contracts to sell at least seventy percent of the output, we must have completed our environmental impact assessment, we must have filed for permits, and we must have finalized the plant design. Then, beyond the eighteen months, let's say we've done all those things, there's still no plant built, obviously, we have subsequent benchmarks provided for in the contract which require us not only to report at intervals to the state on our progress but also to do certain...commit certain acts during the ensuing months. And the next benchmark is at the end of twenty-four months. And it says we must have committed at least one-hundred million dollars, and at thirty months we must have commenced construction. Now, if we fail to do that, then the state has the right to cancel our contract, to terminate our contract, and take the oil back if we've been taking any at all at that time. And the benchmarks go on up to seventy-two months, at which time we must have committed at least one-and-a-half billion dollars.

MR. CHATTERTON:

Thank you. Mr. Chairman, if I may continue. Correct.

On page 33 of the contract...it's under 10.2(3)...I can't keep up with myself...but it says within thirty months you shall commence construction of the petrochemical facility.

MR. HONIG:

Yes.

MR. CHATTERTON:

And, I'm not quite sure what that facility is. I would have no question but what for you to continue and, under this contract, you would have had by that time to commence construction of the core refinery unit, which, basically, is to handle...gives you a product slate. There's no question about that. Beyond, other than that point, I see nothing other than the continual commitment of money to the project. Nothing about that it has to be constructed, or completed, or anything.

MR. HONIG:

Well, there is nothing in the contract that I recall that specifically sets forth the exact configuration of the plant. That was discussed; it was considered. It was agreed by all that would be probably unnecessarily restrictive and would not accomplish for the State of Alaska what it was interested in accomplishing.

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And that was to process the crude oil in-state and to add value in-state. And, so, to say exactly how many towers the plant would have or any other details of the configuration was deemed to be unnecessary. And, money talks and for us to invest at least one-and-a-half billion dollars in a plant, in a facility, means that we'd better be able to process something.

MR. CHATTERTON:

Thank you. Mr. Chairman, if I may continue.

I realize we are all honorable men, but I'm not sure that we will be here five years from now. And, I'll be quite frank with you, I'm paranoid...but they tell me that paranoia is the mother of discretion many times...and so we proceed. Now, in quick summary, in eighteen months you have to have a letter from...a letter unequivocally saying that there is a place that is proceeding, willing, at beck and call, to loan you up to 1.5 billion dollars. At the end of thirty months, why you have had to start construction on a core, at least started construction on something. And, as you pointed out, the contract does say that you will have to have about thirty thousand barrels a day ability for in-state sales, as I recall the contract through here. Now, having accomplished all these things up through this point, why you would be in conformance with the contract, you have no question about that.

MR. HONIG:

Right.

MR. CHATTERTON:

All right. Now, in the meantime, you could be taking 150 thousand barrels a day of crude oil.

MR. HONIG:

Once we have the financing commitment.

MR. CHATTERTON:

Once...yes...after the eighteen months period. You triggered that off. And you can be doing this, and you can be doing very well at this, I might add, financially you can be doing very well at this. And you can build a thirty thousand-barrel-a-day refinery, and you still are in compliance, I believe, with the contract. And you can still spend up to 1.5 billion dollars on that whole project. And you haven't gone beyond that. Now, aren't you in compliance with the contract?

MR. HONIG:

Haven't gone beyond what?

AGO 559433

MR. CHATTERTON:

The thirty thousand-barrel-a-day feedstock products refinery and taking 150 thousand barrels a day of oil.

MR. HONIG:

Well, Mr. Chatterton, you are more familiar with the oil business than I, I'm sure, and if we spend a billion and-a-half dollars and all we have is a refinery to process thirty thousand barrels of fuels a day, I think it will be owned by the bank long before we got that far. Now, as far as intentions are concerned, if I may I'd like to call your attention to...on page 14...to the paragraph 4.21 which says Construction Obligations. As I mentioned, we have to read...we can't take things out of context, and I know you didn't mean to. This says - In consideration of the obligations assumed by each party herein, Buyer will proceed with reasonable diligence to design, construct, start up and thereafter initiate operation of a petrochemical manufacturing facility with fuels refining capacity in the State of Alaska. Such facility shall include facilities for the manufacture of energy fuels, aromatics, olefins and, certainly if you manufacture either of those aromatics or olefins, then you are making petrochemicals, and petrochemical derivatives of such basic feedstocks, and will include "offsite" facilities such as power supply, water supply, port facilities and administration buildings. Final process configuration and production rates of the various products listed above will be determined by (i) marketing considerations based on sales contracts for the products and (ii) process optimization of the overall facility design to produce the desired products in the most effective manner. Variations in process optimization will occur throughout the anticipated life of the facility. Such facilities shall be hereinafter referred to as the "Petrochemical Facility."

MR. CHATTERTON:

Okay. Thank you very much, Sir. Thank you, Mr. Chairman.

CHAIRMAN MILES:

While we're on the cost of the facility, how much will the facility cost?

MR. HONIG:

The rough estimate we have, and it certainly should not be confused as a definitive estimate because, as you know, a definitive estimate cannot be obtained until all the products slate is set and we know exactly what will be made, but the rough estimate that we had made by Brown & (indisc.) is that it would cost approximately 2.5 billion dollars. That includes the offsite facilities

AGO 559434

such as the dock, the port facilities, as well as the utility facilities which would be...

CHAIRMAN MILES:

I think there was some confusion a couple of weeks ago about whether it was 2.5 or 1.5. I was confused on it, anyway. I don't know how that happened.

Why wouldn't, if it is 2.5, why wouldn't that expenditure be included in the contract. The contract only states 1.5. And, if we are using these time and expenditure bench marks, which have been very carefully set out in the contract, why wouldn't it go up to 2.5? The reason I ask is that all state revenue estimates that you've provided are based on a two-and-a-half-billion-dollar total project, and we are, by definition in the contract, including the total project costs back to January of '75. But, if the benefits that you cite to the state over the twenty-five or twenty-seven-year period of the contract total 1.3 billion dollars on a two-and-a-half-billion-dollar facility, if, in fact, we don't have a two-and-a-half-billion-dollar facility, if we only have a one-and-a-half-billion-dollar facility, our benefits are going to be reduced substantially.

MR. HONIG:

Well, I don't know about the last part of that statement, Mr. Chairman, about the benefits being reduced substantially. There would be some fewer jobs, I suppose, and some smaller tax base, but I don't know whether it would be substantial. In answer to your primary question, there were basically two reasons for not going on and on and on up to the two-and-a-half billion or not making the two-and-half billion required in this time frame. One is that, as Mr. Moore has told the Committee, from Bonner & Moore, that a facility of this size must be phased in. It's impossible to either erect or to start up a refinery of this size and this scale all at once. So it must be done gradually, it must be done in phases. And, for instance, the first phase would be the core refinery which you referred to and, along with that, the required utilities for the larger complex and the port facilities. And the next phase might be an aromatics unit. The next phase might be an olefins unit; the next phase might be another olefins unit, depending upon the contracts for the sale of the product. But, it will have to be phased in, and that was one reason for these numbers.

The other reason for these bench marks being what they are is that in negotiating the contract terms Commissioner LeResche said more than once, do not make the bench marks too optimistic. Set the bench marks so that you, in your own feeling, feel they will be obtainable and that we don't have to go back to the Legislature to revise bench marks. So we hope, I think, to beat all of them

if we can...to do better than what's set forth here. But that was the second reason for making it a billion-and-a-half instead of two-and-a-half. As a matter of fact, when it gets past the eighteen-month bench mark, if we succeed in...as we and the consultant refer to it...when we succeed in putting it all together, which means we have the sale of the products in long-term contracts. We'll have the design finished. We'll know what we are going to make more particularly. And we have the financing commitment. When all those things are done. From then on the likelihood of it not going forward is very remote because, as I mentioned earlier, the lenders, the life insurance companies who buy the long-term bonds and commit to buy the bonds, are going to be sure that we have the proper engineers, that we have the proper design, that we can sell the products, that we can make the products we're going to sell, and that we'll be able to repay the debt.

CHAIRMAN MILES:

I see. I think you can understand my concern about that, though, because it's a monumental economic decision we're being asked to make and a billion-and-a-half dollars does represent substantial... I think it's substantially less return to the state than two-and-a-half billion dollars. The tax base alone is a substantially smaller figure.

MR. HONIG:

Yes...I can understand that. I think, though, that sometimes all of us can get lost in looking at what's before us, so to speak. And I think we need to back off and realize that the main thing here from the standpoint of the State of Alaska is to add value to products in Alaska. That's the main thing. And when we get into such a detail as the bench marks, while we think they're good to have, they're not the main part of the project. They're just to help us all be sure it goes forward.

For instance, on the natural gas pipeline, I haven't heard any bench marks mentioned. Does it have to spend a certain amount by a certain time? I haven't heard of it if it does. So, I think this contract goes much further than any I've seen. I don't think the Alyeska Pipeline had any bench marks that had to be met by any particular time...any constraints placed on it by the state, that is. So I think...I'm not belittling the bench marks. I think they are excellent. But I think that to quibble about whether it should have been eighteen months, or twenty-four, or one, or one-and-a-half, or two we lose sight of what the main purpose is. And that is to build a petrochemical facility in Alaska to help Alaska.

CHAIRMAN MILES:

Yes. I wasn't quibbling over the six months, but I was quibbling

over the thing in dollars, and I think I'm damn well justified in doing it.

MR. HONIG:

I didn't mean to infer you were. I think that from what we hear that to build a petrochemical facility, we'll spend far more probably than the two-and-a-half before it's over.

CHAIRMAN MILES:

Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman.

Mr. Honig, I didn't have a chance to thank you for reading that Article 4.2.1. It is certainly the intent, it is your intent, I know, there's no question. It's my intent; it's the intent of the State of Alaska. But, remember my paranoia. And we're down thirty-six months down the line now, after this contract has been signed, and you started construction on a core refinery which can handle thirty thousand barrels a day. At the end of eighteen months you already have in hand the letter that says you have bank (indisc.). You are available at the bank to the 1.5 billion dollars. And, so, here we are merrily going along. You're taking 150 thousand barrels each day of royalty oil.

MR. HONIG:

We may be.

MR. CHATTERTON:

You may be or any part of it. You are, or will shortly, be running thirty thousand barrels a day of it through your core refinery on it's completion and the balance, the remaining 120 thousand, or any portion of it, why...in Article 13 of the contract you can be trading or exchanging any place that you so wish. You're the broker for that. You have title to it, and you're the broker for anything over the thirty thousand barrels a day. That is Article 13 I assure you. It's on page 40 of the copy of the contract I have, which is basically a brokerage clause. If you agree.

MR. HONIG:

I'm sorry. What was the question?

MR. CHATTERTON:

It's page 40. Well, I was mentioning this is a brokerage clause;

It's in the contract. It permits you anything over and above the thirty thousand barrels a day that you're running through the inside-Alaskan refinery, you can dispose of it in any way you wish - sell it, trade it, exchange it. And you have a free hand, do you not?

MR. HONIG:

Not in the...to the extent that I think your question implies. Let's go back to what you termed, and what we termed, the core refinery. I think that we may not be communicating too well there, perhaps.

The core refinery referred to is not a thirty thousand barrels-a-day refinery. The thirty thousand barrels a day item is the minimum amount of fuels we agree, Arctic fuels for Alaska, we agreed we would have the facility capable of manufacturing. But the core refinery, if you have the presentation that you referred to earlier that we made to the Committee on Monday, if you'll look at page 21 of that presentation there is a schematic of the petrochemical facility. And you'll see there that it shows refinery, and it shows going into the refinery crude oil, and it shows coming out the things you mentioned - gasoline, diesel jet fuel, heating oil, and fuel oil. But also out of this refinery you will see that this refinery must also feed the aromatics plant, part of which goes to market and part which goes into the olefins plant, and it also must supply the feed separation plant which goes into the olefins plant.

My point being that, yes, we must have started construction of the refinery. But, once the refinery is built, it will have to serve more than just the thirty thousand barrels. It will have to serve the aromatics plant and the olefins plant. And for us to spend, or invest, a billion-and-a-half dollars in the plant... as I said earlier, you may rest assured that to do it and to live with our lenders...we'll have to build more than just a small refinery to make thirty thousand barrels of fuels.

MR. CHATTERTON:

Thank you. There's no question. I understand that you'll build this in modules and you'll build this refinery, and I'm sure you'll build it large enough to run 150 thousand barrels a day through it. And, until you have the satellite plants, the aromatics plant, and until you have the feedstock preparation plant for the olefins plant, why you're going to ship the bottoms out. They're going to go south someplace. It's obvious. And the products are only going to be used in Alaska to the extent the products can go south.

But, this is the point I'm really trying to get to that bothers me a little bit is...you are, at least at this point, and as I

see this contract, we have a....and there is no economic incentive despite the border-plate language that our intent is to build. But, right now, there is no economic incentive for you to proceed with putting an olefins plant in or an aromatics plant. You are brokering the oil...

MR. HONIG:

I don't agree.

MR. CHATTERTON:

...you are making the products, and I come to the point that the breach of contract clause seems very weak. To me, I'm no attorney, but to me the state is not suffering any economic loss. I'm hard-pressed to see how the state could ever break this contract.

MR. HONIG:

Well, I think that the point I disagree with you on is the statement about economic requirements, or economic incentive I believe is the term you use. There is every economic incentive for us to build the olefins plant and to build the aromatics plant. You may recall from Chem System's presentation, one of their charts showed the projected rate of growth for basic petrochemicals as compared to petroleum products. And they show that the growth in petroleum products is going to be far, far less during the next ten, fifteen, twenty years than the growth and the need for petrochemicals.

The other thing that comes into play on economic incentive is the fact that less value is added by a fuels refinery, and we must add more value than that, in our opinion, in order to support this project in Alaska. We feel that to build a fuels refinery in Alaska would be marginal at best. And we would have no interest in doing so - to build a fuels refinery only. Because it's by adding the value that not only do we create more jobs and more tax base in Alaska, but we also create a more valuable product so that we are shipping out of Alaska not something that we've converted from \$13.00 a barrel to \$17.00 a barrel, or \$15.00 a barrel. But we're shipping something out that now has a value of \$30.00, \$40.00, \$50.00 a barrel in the form of petrochemical products. So, this is why our economic incentive parallels Alaska's desire.

MR. CHATTERTON:

Thank you very much, Sir. Thank you, Mr. Chairman.

AGO 559439

CHAIRMAN MILES:

On that point about the additional phasing in of various plants... I almost flunked chemistry in high school... The only reason my chemistry prof passed me was that I had to promise him not to take it in college. That's a true story. But are aromatics and olefins solely restricted to crude oil-based processing as a feedstock?

MR. HONIG:

Mr. Chairman, I'd like to preface any answer by almost the same preface you made. I don't think I flunked chemistry but certainly the last time I had it was in high school. I'm not a chemical engineer; I'm not a petrochemical executive. Maybe that's why I'm Chairman of the Board.

CHAIRMAN MILES:

They say that about Legislators.

MR. HONIG:

But, as you know, our Chief Executive Officer is Gordon Cain, who was here earlier this week along with our consultants in the form of Chem System, so I have to preface any answer to say that this will be the blind leading the blind, but I'll try to answer your question with that caveat.

Petrochemicals, I suppose, in the U. S. really got a big start on the Gulf Coast many years ago when natural gas was at giveaway prices, and oil companies would build refineries to make gasoline, primarily, and oils that they were interested in. And, kind of a by-product was the gas, which often was flared for too long and is still being flared in parts of the world. And this cheap hydrocarbon, this cheap gas, which, you know, they might pay a nickel in NCF for it at that time, was found to be an excellent cheap feedstock to make ethylene. And so ethylene plants were built. And the ethane in natural gas is still a good feedstock to make ethylene. The only thing that's changed is that it's no longer cheap and it's no longer plentiful, no longer in over-supply. It's still a good feedstock. However, as I believe Peter Spitz pointed out to the Committee earlier this week, there are petrochemical products which cannot be made from ethylene or from ethane. And to make the full spectrum of petrochemical products, the feedstock must be oil. I think he also pointed out something that many people don't realize, and that is, I think he said that ninety percent of the petrochemical plants today are being fed by crude oil, not natural gas. But that doesn't mean that ethane is not good feedstock; it's an excellent feedstock for ethane, but it won't make all the spectrum of products that crude oil will make.

AGO 559440

CHAIRMAN MILES:

Well...okay. Let me try it again, because, if you answered my question, I didn't pick it up. The aromatics plant and the olefins plant, that's a vital part of your plant. Can they be provided feedstock by specifically...from, specifically, crude oil or also gas and, or, gas liquids?

MR. HONIG:

Well, I think that the aromatics can only be made from crude oil. Is that right, Mr. Chatterton? We're in your field more than mine now.

MR. CHATTERTON:

I didn't quite flunk chemistry, but I would say the aromatics' basic feedstock would have to be crude oil and not the gas oils - quote, unquote.

MR. HONIG:

And what about olefins?

MR. CHATTERTON:

Olefins, why that's an unsaturated paraffin which would normally be coming from your gas oils or your methanes, and methanes could be constructed from it. Right.

CHAIRMAN MILES:

Okay. The reason I asked the question is I brought it up once before and didn't feel that there was possibly the strongest language possible which requires the actual processing. And I just wanted to...the actual processing of oil in-state, and I just wanted to find out about that.

MR. HONIG:

Well, if you use the terms olefins or aromatics then you're generally considered to be into petrochemicals.

CHAIRMAN MILES:

Both gas-based and oil-based.

MR. HONIG:

Yes.

AGO 559441

CHAIRMAN MILES:

So, that's what you're envisioning then?

MR. HONIG:

Yes. Yes.

CHAIRMAN MILES:

So, that's what you're envisioning, then, is future gas-based petrochemicals and purchase of gas...

MR. HONIG:

No, not necessarily. This refinery is envisioning running on crude oil as a feedstock. And, as Mr. Spitz told the Committee earlier this week, I believe, it would be designed so that it could also use gas liquids if and when any were available also as a feedstock. But it's not...the project is not centered on the use of gas at all or dependent on the use of gas liquids.

CHAIRMAN MILES:

I see.

MR. HONIG:

When you say gas oils that's not the same thing as saying gas liquids.

CHAIRMAN MILES:

I understand that. But, if we can't make olefins with just crude oil, then there at some time has to be...we at least have to look at the purchase of gas and...

MR. HONIG:

No, you can make olefins with just crude oil. You can make olefins with just crude oil.

CHAIRMAN MILES:

Without any gas liquids?

MR. HONIG:

Oh, yes. You can make the whole spectrum of petrochemicals from crude oil. You cannot make the whole spectrum from gas, but you can from crude oil. Crude oil is the broader feedstock.

AGO 559442

CHAIRMAN MILES:

Which excludes...when you define crude oil, then you're excluding the methanes, ethanes, propanes, and butanes?

MR. HONIG:

Yes. Yes.

CHAIRMAN MILES:

Okay.

UNIDENTIFIED SPEAKER:

Mr. Chairman, just a very brief question. I realize that you want to get into the tele-conferencing, and people are standing by patiently. If I could, for just a moment, I would like to pursue Mr. Chatterton's paranoia. As the bumper sticker says, just because you're paranoid doesn't mean you're not edgy. But, I really, for a million-and-a-half bucks you're going to see not just a thirty thousand barrel capacity.

Say you were producing 125 thousand...processing 125 thousand barrels a day. For the entire length of this contract is there anything to keep you from brokering and selling just plain crude oil for twenty-five thousand...for time infinatum?

MR. HONIG:

No, there's not.

UNIDENTIFIED SPEAKER:

So, there's nothing in the contract that absolutely ties down that all the oil that would be sold to your company, even after given a certain amount of even start-up years, would be processed in Alaska. Is that correct?

MR. HONIG:

That is correct, except that, having invested in the facility, it would certainly behoove us to add as much value to as much product as we can in Alaska. And I can't imagine why we would want to broker when we have a facility to make petrochemicals unless petrochemicals, for some reason, fell on hard times. But normally that would also be reflected in the crude oil price. So, I think that it's not likely that we would be brokering crude oil, because we have to pay the state the full price for that, you know...the full price at the time. So there's no windfall here that would cause us to, or tempt us to, want to broker crude oil. As a matter of fact, the only reason that came up in the

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first place is that, as you know, one of our present owners is Alaska Consolidated Shipping, and that's the company that a majority of its stock is owned by six regional native corporations in Alaska. And they became interested when they formed the company almost two years ago, I guess. They were interested at that time in trying to buy the crude oil from the state so they could ship it. They were interested in the shipping, primarily. And the other stockholder in Alaska Consolidated Shipping being Sea Train Lines of New York. And so, they wanted to do the shipping and create jobs for the natives and create profits for the corporation, then, in turn, for the stockholders. And they are still interested in shipping now that they're a part of ALPETCO. And the only reason that we asked for interim crude at all was the thought that perhaps we would be able to maybe sell some to the Federal Government to put in the strategic petroleum reserves, or maybe...there are not many probable sales because of the glut on crude on the West Coast. But there might be some that we can't even think of now. And we would be able to, while we were building the refinery, be able to buy and ship, and sell, some of the crude. And that was the only reason for the provision.

UNIDENTIFIED SPEAKER:

One other final question in that direction. I'm not a member of this Committee, and I appreciate very much the courtesy of the Chairman allowing me to sit in today. And I'm...although I've looked over the contract cursorily, I'm not into it in all the detail that the members of the Committee are.

Is there any prohibition against you selling the crude, for instance, to the Orient? I know that the oil companies that are producing and members of the pipeline (indisc.) cannot, but I'm wondering...I don't know whether the state is similarly restricted or, in this case, the person that the state sells the crude to.

MR. HONIG:

My information is we could not.

UNIDENTIFIED SPEAKER:

You could not. Okay, that's what I was curious about.

MR. HONIG:

That is on the "no-no" list for export, I think...currently on the Federal level, and we could not.

UNIDENTIFIED SPEAKER:

I assumed that was the case, but, as I say,...

MR. HONIG:

I think it goes beyond just crude oil. I think we could not sell naphtha; we could not export naphtha out of the U. S., even.

UNIDENTIFIED SPEAKER:

Then, one real...last, final question. Getting back to the point on (indisc. - cough) that you mentioned, which is certainly desirable if those are jobs filled by Alaskans...a little less desirable for jobs filled by Oklahomans...

(LAST PART OF TAPE INDISCERNIBLE - END OF TAPE)

(BEGINNING OF SECOND TAPE)

MR. HONIG:

(First part not recorded.) We started it before we were selected - a training program for both shipping and petroleum operations. And we made arrangements with the International Seafarers Training School at Piney Point, Maryland, to take two natives from Alaska as trainees under the sponsorship of our company. And they are rotated and, when they have finished their training, two more will take their place. We also started two natives training at a refinery in Texas, which is about a thirty-five thousand barrel-a-day refinery owned by Sea Train. And we have two natives training there and they, by the way, are getting very good marks. There are very good reports on them. They are interested, and they're applying themselves, and they're learning. And, while those are token amounts as far as people go, it's a beginning. And we, certainly...our intention is to have extensive training programs for Alaskans and to hire to the extent possible in Alaska.

I think we have another motivation perhaps the pipeline did not have, or any pipeline would not have. And that is that we are building a facility in one spot. It doesn't cover nine-hundred or eight-hundred lineal miles. It's all in one place. And, because of that, the history of these plants, as I think Mr. Norris of Brown & Root testified to the Committee this week, the history of this is that when you build a plant such as this a large percentage of the people who work on building it, various trades, end up continuing as permanent employees to work in the maintenance and the operation of the plant. Because they've helped put it together and they're familiar with it and, therefore, they can help maintain it or help operate it. And I think that I heard a statistic that seems to bear this out the other day, and that was that when Collier Chemical expanded its plant on the Kenai eighty-five percent, I was told, eighty-five percent of the additional employees required were Alaskans, which is certainly, I think, a good statistic.

So we think that for all those reasons because of the native involvement in our company, because of what we want to do, and because of the nature of this animal - the construction being in one place - we think we will be able to realize maximum local hire and do a good job with the training.

UNIDENTIFIED SPEAKER:

Mr. Chairman, may I just offer one comment as an expansion on Mr. Honig's point. This project, we are told by our consultants, and certainly that seems to prove true, cannot afford a high turn-over in personnel. It has to have permanent personnel who are stable. And they've found all over the world that the only stable work force that you can have for a project like this is local people - people who live in the area or people who come from the area of the state that it happens to be in or the country, as the case may be. The transit person has no place in this type of an operation otherwise your operation costs and training just go sky-high.

CHAIRMAN MILES:

Yes, I was thinking primarily of the four thousand construction (indisc.)...

MR. HONIG:

I might mention, in addition to that, we worked very closely with the AFL CIO business agents on this (indisc.) agents in their recent meeting here two weeks ago did endorse the project and the contract, and they (indisc.) to be satisfied with all the terms.

UNIDENTIFIED SPEAKER:

Thank you, Mr. Chairman. Thank you, Mr. Honig.

CHAIRMAN MILES:

Representative Osterback.

MR. OSTERBACK:

May I thank you, Mr. Chairman. Now, I would like either one of you gentlemen to answer a question. What will your products be - diesel fuel, jet fuel, or...?

UNIDENTIFIED SPEAKER:

Yes. For Alaska we would make Arctic diesel, we would make some gasoline, and fuels for use in the state. Outside of the

fuels part, we would make the basic petrochemicals, the aromatics, and the basic olefins. And we would make ethylene, we would make propylene, and we would probably make ethylene glycol, we'd make styrene, and we'd make zylene, probably. And then these basic petrochemicals we would hope to be able to bring in plants in Alaska to take those derivative products and make them into a wider range of petrochemical products.

Where this chain stops, we can't know today. But, as you know, a large host of products are made from the basic petrochemicals.

MR. OSTERBACK:

On your fuel, your gasoline, diesel fuel, jet fuel, would you be distributing that in Alaska?

MR. HONIG:

We have said, in our initial application to the state, that we would not...it was not part of our plan to set up a distribution system in Alaska. We would prefer to make those fuels available to existing distribution systems in the state. So, we would make them and sell them to distributors, probably.

MR. OSTERBACK:

Well, the reason I brought this up... Like our airport in (indisc.) Bay when they were using a lot of fuel there - jet fuel- they would have Norwegian tankers and Dutch tankers come in. Are there some regulations between the different countries where they have to take so much fuel from the Norwegian or the Dutch tankers?

MR. HONIG:

Not to my knowledge.

MR. OSTERBACK:

I could never figure out why they'd come all the way over here, you know, to deliver fuel.

MR. HONIG:

That doesn't make any sense. I don't know of any such regulation. I see no reason why they could not use fuel made in Alaska.

MR. OSTERBACK:

Yes. It seems like it would make it cheaper. Maybe they're getting cheaper fuel from over there. I don't know.

AGO 559447

MR. HONIG:

That's a long haul from...

MR. OSTERBACK:

But, they've been coming in there a long time with big tankers. Sometimes we'd have a (indisc.) of tankers. Most of the time it was Norwegian and Dutch tankers.

MR. HONIG:

I see no reason why they couldn't use fuel made in Alaska.

MR. OSTERBACK:

I thank you, Mr. Chairman.

CHAIRMAN MILES:

Mr. Honig, the...I understand that the Department of Environmental Conservation believes an environmental impact statement may be necessary on the project. This is kind of a lengthy procedure; is that going to back you up at all if that requirement comes out?

MR. HONIG:

We hope not, and we will begin immediately on it once the contract is approved. We were hesitant, as were the other applicants, to spend large amounts of money on any phase of the forward movement of the project until the state had made a selection and decided what it was going to do.

CHAIRMAN MILES:

How long might it take in your estimation to (indisc.)?

MR. HONIG:

I think that it would probably take a good portion of the eighteen months that we have to prepare that...to do that. As you know, we have not finally decided on a site even at this point, so it would be impossible to begin that work unless we did it at a number of places until the site selection has been determined.

CHAIRMAN MILES:

Additional questions? Mr. Pratt.

MR. PRATT:

Mr. Chairman, if I just might, with one final remark, call to your

attention the copy that I think we provided the Committee last Monday - Project Information Submitted to the Institute of Social and Economic Research - will perhaps provide Mr. Chatterton and yourself with better insight to the product mix that we anticipate at this particular point in time. The income statement shows the breakdowns of the olefins, the aromatics, and the fuels. And I think may very well provide you with some of the information you were curious about.

MR. CHATTERTON:

Mr. Chairman. Thank you, Mr. Pratt. I do recall the rather illuminous reports that you have filed along about, I think, October 15th or so, and if you haven't materially changed your product mix, why, I suspect I know a little about what it is. Thank you.

CHAIRMAN MILES:

Are there additional questions from Committee members? If not, it's the Chair's intention to call a five minute recess, and give Mr. Honig a chance to get a glass of water. And I suspect we may have some questions, Mr. Honig, from Anchorage, Fairbanks, and Nome if you could stay around to respond to any statements. It would be helpful.

MR. HONIG:

Be very glad to.

CHAIRMAN MILES:

Are there other witnesses in Juneau that would like to make a statement? Okay. As there are none, I would ask Carol, and April, and Myrtle in Anchorage, Fairbanks, and Nome to stand-by. We are going to take a very short break and will be back and will begin testimony in Fairbanks. We will go to Nome to see if Miss Johnson has any witnesses and then to Anchorage.

It's the intent to take one witness from each of the areas until all witnesses have been heard. So, again, we will start in Fairbanks, take one witness from Nome, and then one from Anchorage. And right now we will take a very short break.

(RETURN FROM BREAK)

CHAIRMAN MILES:

We will call this meeting of the House Royalty Oil and Gas Committee back to order. It's my understanding that there are two witnesses to testify in Fairbanks and one in Anchorage. It's also my understanding that the Fairbanks witnesses have delayed

attending other meetings to present testimony to the Committee. If there is no objection from Anchorage, I would like to proceed with taking both the Fairbanks witnesses, contrary to what we said before, because they are in a hurry to get to other meetings. Is there any problem in Anchorage, Miss Dickinson (ph)?

MISS DICKINSON (ph):

There'll be no problem, Mr. Chairman. It'll be fine.

CHAIRMAN MILES:

Thank you very much. That being the case, we'll now go to April Moore in Fairbanks with her witnesses.

Miss Moore, if you could, could you give us a count from one to ten so we could adjust our volume here in Juneau?

MISS MOORE:

Mr. Chairman, one, two, three, four, five, six, seven, eight, nine, ten.

Our first witness will be Dr. William Wood, and I'm going to ask him to introduce himself to you at this time.

CHAIRMAN MILES:

Thank you very much. Dr. Wood.

DR. WOOD:

I've just been waiting here, but not patiently, for about an hour and three-quarters. This is a Saturday in Fairbanks with bright, blue skies, and full of sunshine, and the North American Sled Dog Championship, and the Winter Carnival, and I don't know what all else goes on.

CHAIRMAN MILES:

Be glad you have sunshine, Dr. Wood.

DR. WOOD:

(Indisc.), if that's what you were requesting. I am (indisc.) the President Emeritus, University of Alaska. I have read the preliminary ALPETCO proposal with the late John Barber, discussed the details with the Fairbanks Industrial Development Board last summer. I have read the revised and the standard proposal now up for final consideration by the State Legislature. I have examined in depth the rationale behind the ALPETCO proposal and applauded it. I have studied the outline of the contract negotiated

by the State Royalty Oil and Gas Board. I have not had an opportunity to examine the final contract wording. It's up to the elected representatives of the people of Alaska to do just that.

State Government represents the residents of Alaska. Industry represents stockholder residents of Alaska and elsewhere. Both represent people. The ALPETCO proposal recognizes this fact by showing interest in and concern for people; in particular, the people who choose to reside in Alaska. It states, without fanfare, the advantages to Alaskans of making use of the human value-added concept. What's more (indisc.) in presenting the case where opportunities provided Alaskans by the petrochemical project is not just to earn a living but for the satisfaction of using one's enthusiasm, energy, skill, knowledge, and creatability to good purpose.

The proposed petrochemical project would create nearly three thousand very desirable jobs directly and about seven thousand to nine thousand as secondary and tertiary spin-off, or supporting, services jobs. These jobs are badly needed in Alaska if our present crop of high school and university students are going to have a fair chance to continue to live in this state. I'm particularly aware of this point as I've just spent the week on a project visiting each of the five high schools in this area to talk with juniors and seniors concerning their career plans. This is part of a local Rotary Club project.

In addition to the jobs I have mentioned, there are also those unknown (indisc.) government jobs, both the necessary and the unnecessary, that will undoubtedly come about as a result of the project. The taxes, local and state, to be derived from the project would be substantial. It would make possible social, educational, and cultural improvements that likely could not be accomplished otherwise.

The day is past when Alaskans can rely upon the fond, but futile, hope that someone will come along to do something nice for us someday. ALPETCO shows concern for Alaskans by proposing to establish in Alaska endowment trust - a charitable trust fund to improve its social, educational, cultural, and environmental conditions in Alaska. This is a generous proposal, and most companies don't make this. You have to go and ask them for contributions to various items of this sort.

The risks to Alaska in processing natural resources in the state, when you gain the tremendous rewards for applying the valued added, are exceedingly minimal, in spite of all the consultants you have heard...exceedingly minimal under the contract that's proposed for approval now by the Legislature. Anyone can find fault with another's proposition. It requires no genius (indisc.), not even very much brain power, and practically no courage. Whether it's one person with an idea and determine to propel that

idea into good use, it is easy to find a hundred to find fault with a proposal to say it won't work...and a thousand who would sit on their hands and do nothing. Doing nothing with natural and human resources is a way to remain in colonial status forever. The road to serfdom is paved with doing nothing.

I can be a very suspicious old man where big industry, or big government, or big social, do-good causes are involved. On the ALPETCO project I have no reservation of consequence. John Barber was completely convincing in presenting the initial proposal to us. The improved version, now for a decision, is an opportunity Alaskans cannot, in good conscience, afford to miss. The proposal merits the support of Alaska. Thank you very much.

CHAIRMAN MILES:

Thank you very much, Dr. Wood. Your message is certainly quite clear and convincing.

MR. HONIG:

Mr. Chairman, may I make a comment in response to Dr. Wood?

CHAIRMAN MILES:

Mr. Honig, you have the floor, Sir.

MR. HONIG:

Dr. Wood, you mentioned the late John Barber and I know you felt as we do that there was no one who was more dedicated, or determined, or energetic, or enthusiastic than he was about this project. And, you'll be interested to know and we so informed the Committee on Monday that it is our intention to name this refinery in memory of John Barber.

DR. WOOD:

I'm delighted to hear it. He was no one's fool. I don't think this was his idea originally, as he explained it. But, as he worked on it, the idea grew upon him. He saw its possibilities, and he dedicated himself to it. And I admire a man of that caliber.

MR. HONIG:

We all do.

CHAIRMAN MILES:

Dr. Wood, one final comment...Bill Miles speaking. I would like to make you and other Fairbanksans aware of the statement that Bonner & Moore, the consultants on this project, have made concerning

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the petrochemical refinery, and I'll quote directly from their report. This is a quote: "If the state were to award a royalty oil contract to a group proposing to build a fuels refinery, then royalty gas could be considered independently. If the state were to award a royalty oil contract proposing to build a petrochemical refinery, then it should be understood that natural gas liquid availability, at the right price, would likely require that the oil project be abandoned or converted to the use of natural gas liquid if that option were within the power of the state." End of quote.

I think that residents of Fairbanks, as actively in pursuit as they seem to be of various options concerning the development of the gas industry, should be aware of that finding by the consultants.

DR. WOOD:

We have a small refinery here at the North Pole; one which is taking care of local needs, and the products come from the refining of the crude, twenty-five to thirty thousand barrels a day, and that will go up, we think. And we're delighted with it, frankly, and we hope that it will continue to be the success it has every promise of being.

Now, we're deeply interested in the gas fuel of petrochemical development in Alaska, and we realize that this is complementary to the development of the petroleum fuel petrochemical plant that is under consideration now. And I don't see that there is any conflict that they'd have to work together. And I don't see where you would have to shut one down once the other one began. I've not found anyone that I've talked with in the petrochemical field that would say that this is so. I've talked with people from Dow and some of the other major petrochemical companies, and that isn't their opinion. I don't (indisc) Bonner & Moore make this statement; perhaps I don't quite understand all of the nuances of what they've written. I've read the statement.

CHAIRMAN MILES:

It's certainly not my intention to debate the issue with you or anyone else, but it is a statement by the consultants and we have a responsibility to take all information into consideration before making that decision. It's a statement which directly affects Fairbanks.

DR. WOOD:

Well, if the project is good for Alaska, it will be good for Fairbanks. I think we are determined to see that that's true.

CHAIRMAN MILES:

Thank you, Doctor. I think our Representative Chatterton would

like to make a statement. Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman. Good day, Dr. Bill. How're you doing?

DR. WOOD:

Very fine, Chat...very good.

MR. CHATTERTON:

Dr. Bill, I am sorry that my hopefully searching and not nit-picking questions were causing you to wait impatiently, but let me ask you one question.

DR. WOOD:

(Indisc.) is equal, and we could read your discussion. I wasn't just spending a Saturday afternoon listening to the hearings, I wanted to have something to say in the hearings 'cause that's what I thought the exercise was all about. I must have misunderstood.

MR. CHATTERTON:

That sounds fine. No question in your mind, why, whatever we do down here you want to see it done in the best interest of the people, I guess, of Alaska. Right?

DR. WOOD:

(Indisc.), or we'd change voices.

MR. CHATTERTON:

Sounds great. Have a good day, Dr. Bill.

DR. WOOD:

The same to you, Sir.

CHAIRMAN MILES:

At this time, April, can you bring the second Fairbanks witness forward, please, and ask him or her to state their name for the record?

MISS MOORE:

Mr. Chairman, our next witness will be Mr. Terry Palczer.

MR. PALCZER:

Thank you, Mr. Chairman, and Committee members for the opportunity

to testify, finally. I, too, have been waiting impatiently but enjoyed Mr. Chatterton's searching comments on the contract.

I will preface specific contract provisions with a few general comments.

CHAIRMAN MILES:

Can you state your name for the record, please, Sir?

MR. PALCZER:

It has taken considerable effort to produce these contracts, particularly the sales price...

CHAIRMAN MILES:

Excuse me. Can you please state your name for the record, please?

MR. PALCZER:

Terry Palczer, Fairbanks, Alaska.

I will preface specific contract provisions with a few general comments. It is (indisc.) the administration has undertaken considerable efforts to produce these contracts, particularly the sales price provision for Legislative consideration. And, for that, the Administration is commended. Public input would have been appreciated in the administration's negotiation stages. It is recognized that this Committee, the (indisc.) Committee, or the Legislature must either approve or disapprove the contract's (indisc.). It is also recognized that an expeditious recommendation by this Committee, (indisc.) Committee, and/or Legislature could be incorporated by the administration, the Royalty Oil & Gas Advisory Board, and ALPETCO with due consideration and speed. With a considerable amount of give and take, and through verbal negotiations, it is unconceivable that the working relationship that exists will expedite any proposed modifications to the contract.

The (indisc.) to specific provisions (indisc.), the following comments were presented. Article 2.2 Initiation of First Delivery recommends that deliveries start concurrently with the operation and production of the first phase of the petrochemical facility. Article 2.4 Buyer Option in the Event Certain Quantities Not Delivered. I question the obligation of future royalty oil by negotiated sales rather than through competitive processes. But also ask, if this provision is included in the ALPETCO contract, that the NPR (ph) contract, North Port Refining (ph) contract, is also strengthened with these guarantees.

Articles 4.2 and 4.3 - Construction Obligations and Production of Energy Fuels for Intrastate Use. I interpret this to mean

that the minimum requirements are to provide facilities for a thirty thousand-barrels-per-day fuels refinery. I question whether this necessarily obligates ALPETCO into the long-term 1.5 billion-dollar investment.

Article 4.2.2 Siting of Petrochemical Facility recommends a change in the time limit for the Commissioner and ALPETCO to select site. It presently reads that in a succession of (indisc.) each selection has as much as a six months' delay. Specifically, the Commissioner must respond in ninety days on each specific site selection, and ALPETCO, in turn, has another ninety days to respond ad infinitum. There is no time limit in that respect.

Article 4.4 Establishment of a Charitable Foundation. I suggest that the contributions begin upon financing production instead of ten years after production starts. (Indisc.) in the future, potentially in the middle nineties.

Articles 5, 6, 7, 8, and 9. I think that the basic (indisc.) for having accounting procedures appear to be complete. As provided by Article 2.2 and Article 13, ALPETCO could potentially become an oil broker (indisc.) at the citizens of Alaska's expense.

Article 10.2 (10) suggests re-modification. There is too much latitude for delay, plus the opportunity to re-negotiate the terms of Article 10.10...excuse me...Article 10.2. Specifically, if you add up all the time frame that the Commissioner has for planning delays, there are fifty-two months of potential delay in the over-all project. What if the time required for delay potentially happened from (indisc.).

Article 10.3 Termination by Buyer suggests a change to a (indisc.) termination with only two sites selected...that's the present terms... with only two sites selected. This suggests a modification along with 4.2.2. of the considerations previously discussed. This one refers to ALPETCO has the option, terminate its agreement, along with other agreements, after two sites have been turned down by the Commissioner. There is no consideration by the buyer for premature, which I interpret as premature, termination.

Articles 11 through 24 (indisc.) comment except with Article 13 in regards to the offering of oil.

Article 25.2 Local Training suggests that a change be incorporated; that there should be a continual program of local training as job opportunities permit. The natural limitations do not adequately address this program. Potentially, ALPETCO would not have to expend any dollars if outside sources materialize in sufficient quantity.

Finally, I have just a few editorial comments. The contract (indisc.) described is offering no risks (quote-unquote) to the

State of Alaska. I propose that a risk associated with the failure of the added value concept to create benefits to the people of Alaska is of concern. The strengths of the contract are in the oil pricing, billing, and accounting procedures rather than the insuring of no risk of jobs, benefits, etc.

Additional covenants, similar to Article 5.5 Covenant to Aid in Obtaining Governmental Permits to assist in the other (indisc.) of the project - for example, to assist in feasibility financing, to assist in locating a suitable site without trying to find out if there is a site that's (indisc.) a suitable site, to assist in minimizing the risks that do remain - the one of non-performance. I'm concerned that ALPETCO may opt out of the agreement. Essentially, (indisc.) these agreements are (indisc.) to purchase for a more profitable adventure such as petrochemicals and natural gas liquids feedstock. The (indisc.) being buying time by the administration in an election year promoting development and of ALPETCO having an edge in future ventures as described above. (Indisc.) constructive (indisc.), the intent being to strengthen the (indisc.) and ensuring in-state profits of the royalty oil.

Hopefully, the recommendations of this Committee will serve to not necessarily approve the contract, due to scare tactics of some that any modifications will kill the agreement, but to act in the full interests of the people of Alaska. Thank you very much.

CHAIRMAN MILES:

Thank you very much, Mr. Palczer. Are there comments or questions from the Committee?

Thank you very much, April. We certainly appreciate the comments from Fairbanks. As usual, they are to the point, direct, and most interesting and helpful to the Committee deliberation. If there are no further comments from Fairbanks, we will now switch to Carol Dickinson (ph) in Anchorage.

Carol, can you come in, please?

MISS DICKINSON (ph):

Yes, Mr. Chairman. We have just one person wishing to testify, Mr. Jerry McCutcheon.

CHAIRMAN MILES:

Thank you. Mr. McCutcheon, you may have the floor, Sir.

MR. MCCUTCHEON:

For the record, my name is Jerry McCutcheon.

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If this is a preliminary hearing to obtain data on the irregularities of the contract negotiations and send it back to the administration, this doesn't make sense. But if this is a hearing in which you are going to say you approve totally, then it's a little (indisc.) from the public to (indisc.).

If we have (indisc.) follow the pattern of another El Paso gas bill, and another Cooke Inlet land swap where the State of Alaska got bilked out of about five billion dollars of minerals. I fail to see why this contract is before the Legislature. I have it on reasonably good authority that the contract is still under negotiation as late as the early part of this week. (indisc.) the contract really doesn't belong (indisc.).

Next, the law says, not just one but many times, the Commissioner must have prior written permission for (indisc.) in the contract. And, if you are going to accept that, it seems to me we should (indisc.) a law, if we shouldn't sit there and say...well, the law doesn't really mean what it says, (indisc.), it means something else because there's a lot of things somewhere else that say something different. I think we should really get the clear intention (indisc. - cough) that read the law. Otherwise, we are going to render our laws and our contract negotiations meaningless, and anyone in the future who (indisc.) Alaska is going to realize that they are not going to be able to negotiate a law, or (indisc.) a transaction, because somebody has probably already gotten the inside track. And, if that happens to be them...it's great, but, if it's not them, why they're going to be out.

There are legal questions over prior written permission and then there's a legal question over the sale of oil from yet undiscovered oil reserves. I won't go into it too far, but you have a staff and I suggest you look at those. And, if you have doubts, then hire an independent expert, one who's really independent, and render an opinion. Not like I've seen some other people (indisc. - cough) on the El Paso contracts where the other consultants were hired to render opinions which were favorable rather than which were more factual and representative than a broad section of opinion might be had in the market place.

I can find no evidence that the Royalty Board addressed a number of various issues that it has supposed to have addressed before approving any contract. I think there's six, or seven, or eight various items that (indisc.). I can find it in none of (indisc.). I don't know whether it can be found in writing as to what determination has been made.

There is substantial evidence that the negotiations were other than an arm's length transaction. The obtaining of a (indisc.) public opinion poll that should publicly be receptive to less than a fair market price for a (indisc.) to promote a plant in Alaska. Then all the participants were told that only fair

market price would be accepted. Well, then, there was one who was encouraged to submit on the basis of being able to go to the public and obtain a reduction. You can be sure they will go to the public. They'd be damned fools if they didn't. (Indisc.) it's a corporate interest once they have started to maximize their return and their yield and (indisc.). You have six regional corporations, I understand, and you have the (indisc.) at which the plant is located, then you have the region where the plant is located, all of which would be affected by the plant. And if a state-wide candidate were to have that many votes in his pocket, he would be unbeatable. But, it's worse than just that. There is no other candidate. It would be a one-man race with no opponent, and millions of dollars would be dumped into the election. And that combination should not be permitted to happen. If you're going to rubber-stamp this contract, at least change that section of the contract so that as much money must be spent in opposing any reduction as is spent for.

The (indisc.) that appears in the contract does not change (indisc.), serves notice (indisc.) the State serves notice, and there is no (indisc.) but it's going to take oil. And, after it serves the notice and the (indisc.) is now beginning to take it on, then a court suit is mounted, and ALPETCO is prevented from taking the oil, and the producers have made other arrangements, are we going to be in the same jackass position that we got into in Anchorage International Airport after the Hammond administration destroyed the prettiest stand of timber in Anchorage to build a runway which is scheduled to be abandoned in 1990? And now the State has brought the proceedings, and we'll probably lose Federal financing for the project.

I think the risk here to the State of Alaska is just far too great to bear. The contract should be returned and no negotiations re-opened. If ALPETCO has really made the best offer, and is sure of itself, it would surely again win the contract. They are not sure, and they know that attending the special (indisc.) at less than arm's length transactions would not...they would not be able to gain those advantages again. At this time, I think giving the same conditions which ALPETCO's got the contract under, I think we'd see far larger and more knowledgeable bidders enter the arena.

Again, I can't see the hurry on the...with this project or this contract. (Indisc.) here (indisc.), I guess we used to call it (indisc.) scouting services, a remark by Fish & Game. Fish & Game seeks to (indisc.) on the selection of a refinery site. The Commissioner of Fish & Game, Ronald (indisc.), has recommended that the State delay for two years the decision on a refinery site for processing Alaska's (indisc.) royalty share of Prudhoe Bay oil. He said the delay would allow the completion of the environmental studies to determine the effect of the refinery's

discharges on the fish. (Indisc.) said he told Commissioner of Natural Resources, Herbert (indisc.), in a recent memorandum that the studies are needed to evaluate the potential effects of waste (indisc.) on fisheries and biological productivity of a potential site. The Commissioner of Environmental Conservation, Ernest (indisc.), noted his department would issue such permits for such studies, as (indisc.) opinion will be considered along with those of other agencies as well as the general public. He also said he believed the State selection will be made on criteria other than water (indisc.) if water (indisc.) the issue.

Well, if we're in good company (indisc.), I don't see why we can't take a couple of months off and do this thing right instead of all the (indisc. - cough).

With the letter of financial commitment, I thought of the very kind of letters that came...internal letters that came by the State and the City of Valdez when prospective bidders on land in Valdez... and they are totally meaningless. What they do is they go get a letter and then they go get another letter, which they don't make public, and it tells the bank that they're all sewed up. It's done all the time. And I think you're going to have to get that part of the contract very iron-clad and it's going to have to be under oath and the bank's assurance for committing. It's no trick at all to get those kind of letters of commitment.

Then there's the subject of...that was raised here about flooding (ph) California's oil. California is already flooded with sulfur (indisc.)...sulfur-content oil. And oil wells are already being shut-in.

There is a possibility that Alaska's products, or Alaskan production, may be curtailed (indisc.). The Carter Administration may be forced to relent and allow an oil trade to Japan or Canada. I think Mr. Chatterton probably apprised you more of the situation when the question was raised (indisc.) oil and gas (indisc.).

The trade question, I'm going to open a crack in the door now, raises the question what will happen if the trade is allowed to proceed. Would the so-called enormous profits then inure to ALPETCO, or would they inure to the State? Second, it is my guess that if the Legislature would go to the President and get a concession for the state's royalty oil, and (indisc.) the state's royalty oil, I'd think he'd more than welcome the chance to make the exchange. Or at least...it would help him escape from the situation that is now out on the West Coast or which could ameliorate the growing glut on the West Coast. I wouldn't go to a Congressional delegation. I'd get a consultant like (indisc.) Doscher (ph) who'll (indisc.) a compre-

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hensive docket (ph) and (indisc.) delegation from the Legislature to raise the questions of the draft and let them take along their expert.

I would also like to note at this time the Doscher and Dougherty Report which the Legislative Affairs (indisc.) distributing is not the final draft. And I didn't know that until yesterday. (Indisc.) parts of that report (indisc.) the draft (indisc. - fades).

Returning to the contract at hand, I find no indication that a plant with gas liquids was considered versus the plant based upon oil. And, if we're going to be again in the position of where we only have one plant, then shouldn't we take the best one we can and run with that? It is my understanding, and this I just heard again when Mr...Chairman Miles quoted from the Bonner & Moore Report, and that's not my source, that a plant based upon gas liquids would drive a petroleum-based petrochemical plant - if they were both located in Alaska - right to the wall. And, if this is true, and again (indisc.) that they are located in Fairbanks, are we Alaskans going to have to subsidize ALPETCO? Or will the State be willing to.....would the State be willing to subsidize ALPETCO, in this case? Or would ALPETCO, having been on the scene, being given the possibility of a State subsidy, preclude the possibility of a gas liquids plant? I think this becomes important, because we have, at this juncture, an outlet for our royalty oil. While we may not be getting very much for it, far less than was ever anticipated, that is the problem of the Administration and the Legislature. But it is probable. The question about the gas liquids.... We do not have an outlet for our gas liquids at this time. And at what the market might be, I think it's very important, and (indisc.) the Bonner & Moore stage and (indisc.) variety studies, it appears that the shipping of the gas liquids and their shipment to an area such as Fairbanks is still, at this juncture, an economic possibility... with or without a gas line, and I don't think that gas line is ever going to go.

I appreciate Mr. Chatterton's remarks the other day. (Indisc.). This question of having one competitor like ALPETCO and another competitor, say like a plant based on gas liquids, which is un-subsidized, raises the question - should the State of Alaska engage, or allow itself to be engaged in such a manner that it enters the private arena in private enterprise? It (indisc.) to subsidize one competitor against another competitor, of both in the same state? (Indisc.) of gas liquids, but apparently we have another one of the competitors which is interested in this project, and wasn't expected, is about to proceed purchasing oil from the North Slope producers and have built a plant in Valdez. But the State, in view of that, still belongs in the business with the possibility of allowing a subsidy at a later date.... and subsidizing one competitor against another.

We have questions not only about possible dishonesty in the way the contract negotiations were handled, we have philanthropical questions about possible subsidy and the role of the State as subsidies and I'd like to return now to the question of future reservoirs. It seems to me that it says here supply. Supply means that amount of oil or gas that is reasonably anticipated to be producible and deliverable from (indisc) known reservoirs when a specific time period approved by the board (indisc) this section. If you think and quickly run on your computer, you will find that 150,000 barrels a day for the life of this contract would run to 1.4 billion barrels of oil. Now the operators on Prudhoe Bay despite all their balleyhoo and State of Alaska's administration of Natural Resources balleyhoo, is only (indisc) to produce 6.5 to 7 billion barrels of oil. The royalty share of that is a little something less than 900,000,000 barrels. That means that this potential of another 600,000,000 barrels open here. I'd like to know where it's going to come from. Is it -- there's a total lack of appreciation of what the (indisc) reservoir really amounts to and just how large and big it is. That reservoir is the crown jewel of the western hemisphere is the biggest one we have ever found. There are oil fields that are larger in the western hemisphere than that, but the single reservoir of that kind of oil is not. The probability -- there is no probability that the State of Alaska has found another one on its land. It (indisc) less to do about it and there are other rumors that there might be one under the Arctic Wildlife Range, but that -- concocted by myself and Less Gregg (ph) in Don Young's office about 4 years ago. So I really don't think so. It's just (laughter) (indisc) certain issues. From 1970 to 1976, we only found 2 billion barrels of oil in the United States, that's all. So for the next 7 years we quote (indisc) rate, if all discoveries were to be found in Alaska, we could not reach the requirement for this bill, the one-eighth or 2 billion, Or 250 million barrels and you are still substantial (indisc)

It just doesn't seem to be very real. Even if you projected this on to the necessary amount of decades, that it would take, it literally is committing the State of Alaska to all the oil they get in the future. And I don't think that your -- the State of Alaska is even going to find enough oil to actually satisfy all the requirements that this contract may imply and probably get -- and for the most probable implications which will occur from it because of the (indisc) go to get a reduced price in opening up the contract negotiations again.

I think I'd better quit at this juncture. Thank you very much.

MR. CHAIRMAN: Thank you very much Mr. McCutcheon. Are there other witnesses Miss Dickinson in Anchorage?

MISS DICKINSON:

No, Mr. Chairman. There are none.

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CHAIRMAN MILES:

Well, thank you very much Carol in Anchorage, and April in Fairbanks. We certainly appreciate the time that the witnesses put in the unexpected delay and certainly feel their testimony was valuable and with that we'll sign off on the teleconference portion of this hearing. Thank you again.

UNIDENTIFIED SPEAKER:

Bill, do you have a question for the (indisc) ?

UNIDENTIFIED SPEAKER

There is one question. Where'd she get the idea this contract is still under negotiation?

CHAIRMAN MILES:

Would you like to raise that?

UNIDENTIFIED SPEAKER:

Yeah, why don't you ask that.

CHAIRMAN MILES:

Carol, in Anchorage, are you still there?

MISS DICKINSON:

Yes.

CHAIRMAN MILES:

Yes, there's one question that Representative Chatterton would like to raise, with Mr. McCutcheon. Is he still there?

MISS DICKINSON:

Yes he is.

CHAIRMAN MILES:

Okay. Representative Chatterton.

MR. CHATTERON:

Thank you Mr. Chairman. Jerry, a quick question. You mentioned at the start of your testimony there something about the contract still being under negotiation. As far as I think any of us here understands, why that is negative. We've got a firm thing before us that we're reviewing. I hope there isn't anything

following. Could you sort of enlarge on that comment please?

MR. MCCUTCHEON:

Well, this is one of those things that I heard from a very reliable source the other day at the Royalty Oil and Gas Board Hearing and I'd rather not go beyond that. You can check it out for yourself. You'll know if all of a sudden you wind up with a slightly different contract in your hand or the best way I suppose is to call the administration before you and ask them. But I'd certainly -- I'm just passing a little hearsay information and I'd rather not go beyond that.

MR. CHATTERTON:

Thank you Jerry, very much, I appreciate it.

MR. MCCUTCHEON:

You're welcome.

CHAIRMAN MILES:

Are there other questions for Mr. McCutcheon? Thank you again Mr. McCutcheon and Carol. We appreciate your time and to you also April and the witnesses in Fairbanks.

MISS DICKINSON:

Thank you Mr. Chairman.

CHAIRMAN MILES:

If there's nothing further then to come before this committee, we'll be placing an adjournment motion shortly. Do you have a final comment Mr. Honig.

MR. HONIG:

I think Mr. Pratt may have.

MR. PRATT:

Yes, I've turned this off. Mr. Chairman, if I might, just a very brief statement that I had not intended to give, but I think that it is appropriate. Should this be on or off? I think it's interesting to note that no one in our group and no one in the administration has used any scare tactics and I don't believe there's been any hurry before the legislature, at least not on our part. But I think it is significant to recount somewhat the history of a few items. And unlike the royalty gas contracts

the entire process of sale leading to the resolution before you, has without question been the most thorough over an extended period of time of almost a year, with substantial public participation, administration participation, and legislative participation. The State Energy Policy Committee with you as Chairman, Mr. Miles, and five other members of the legislature began its participation in the royalty oil sale early last fall and continued until January of this year. On December 6 the Energy Policy Committee made 11 contractual recommendations to the Governor. The specific recommendations included 11 different clauses in the contract. In addition you made 6 policy recommendations. All of this input was not available to the negotiation of the gas contracts last year and in addition, the Energy Policy Committee, I believe, adequately kept the members of the Legislature informed on on-going negotiations of the various proposals including the various contract proposals. I personally feel the Legislature should be commended. It was the Legislature last year which directed the role the oil should be taken in kind and it was the Legislature which established the State Energy Policy Committee. For the first time Alaska has a framework for an energy policy plan and for the first time the Legislature has had considerable input into a royalty sale of natural resources.

The royalty oil contract before you between the State of Alaska and Alaska Petrochemical has great potential for the people of this state and the several thousand permanent new jobs and the millions of dollars of tax revenues, the endowment trust and in providing new industrial base of development for the state. All through what we in ALPETCO consider to be a non-subsidized, no risk contract. This Legislature has the unqualified opportunity to be the first in Alaska's history to lay claim to having established the first major industrial base for a stronger and more stable future. I think that with those remarks, I am not urging you into any action. I'm sure that you're going to take a great deal of further consideration. But I do want to remind the committee, and more particularly the public, that the Legislature has been working on this diligently for some time and I'm sure will continue to work on it for some time and I would not like the impression left that you did not know what was going on and nobody else knew what was going on throughout the last 12 months.

Thank you Mr. Chairman.

CHAIRMAN MILES:

Thank you Mr. Pratt. To your statement just a short response. The knowledge that we have with the exception of the formal letter was knowledge gained in hindsight only to the deliberations when Commissioner LeResche would bring myself or other members up to speed it -- insofar as the State Energy Policy Committee was concerned we did represent the 11 formal contractual recommendations to the Governor and Commissioner LeResche, but generally the knowledge we had was after-the-fact and sort of a reporting -- sort of a reporting sampling. I think that's a -- that is important that we record that -- have that response

recorded.

Are there final comments from committee members? Representative Chatterton.

MR. CHATTERTON:

Thank you Mr. Chairman. I don't know -- trying -- rolling around in my mind protocol here so I think I will address this question to you Henry. Representatives of your clients met with the Governor in Anchorage yesterday. Did they?

MR. PRATT:

At a public meeting? Is that the one you are referring to?

MR. CHATTERTON:

I'm asking you if they met.

MR. PRATT:

Yes.

MR. CHATTERTON:

Was that a public meeting? You led me to a question now.

MR. PRATT:

Yeah, it -- my understanding of it is representatives of our company up here with the Governor yesterday at a pre-planned public meeting on the entire royalty oil contract.

MR. CHATTERTON:

Right.

MR. PRATT:

Fairbanks the day before.

MR. CHATTERTON:

To your knowledge during public or non-public, was there any discussion of modification of the contract that this committee has before it?

MR. PRATT:

I have no understanding or idea of what took place at either meeting other than there were some 60 to 70 people there and that there was a question and answer period.

MR. CHATTERTON:

Would you be willing to find out for me by Monday whether there was any further discussion of any changes in the contract, please?

MR. PRATT:

I'd be very happy to to the extent that I can and perhaps maybe Connie Barlow can also inquire from the administration's point of view.

MR. CHATTERTON:

I'd appreciate it. Thank you. Thank you, Mr. Chairman.

MR. HONIG:

Mr. Chairman, if I were to make a response to that question which has been raised as Chairman of the Board of ALPETCO, I know of no discussions conducted by anyone in ALPETCO or with anyone in the administration with respect to consideration of any change of any sort in the ALPETCO contract, and I think if that had been discussed by ALPETCO representatives, I think I would have heard about it.

MR. PRATT:

Mr. Chairman, I'm sorry, I didn't even understand the thrust of Mr. Chatterton's question. I thought you meant that any members of the audience suggest changes to the contract such as Mr. Paulser (ph.) did.

(Simultaneous speech. Indisc.)

MR. PRATT:

I'm sorry, I did not understand your question. I also would like to make one other response and may it in a very serious vein. Mr. McCutcheon of Anchorage made a reference to questions regarding the dishonesty in the way the contract negotiations were handled. I not only resent that comment, but I know of nothing that could even resemble such conduct at any time during the negotiations. Mr. LeResche, in my opinion, and in the opinion, I think, of the other applicants, conducted all of the negotiations on a very high plane and in almost an aloof manner as far as any of the applicants are concerned, and certainly there was never any hint that any of us noticed at any quarter of any dishonesty whatsoever.

CHAIRMAN MILES:

Thank you very much. Any further comments? Then we'll stand adjourned.

AGO 559467

March 18, 1978

1665
1448
217

House
Special Committee on Royalty Oil and Gas
Public Rebuttal

Testimonies, testimony to Roy Board,
Berman
Bill Rice

ALPETCO - Charles Honig

Risks & rewards & subsidies

Subsidies - Direct or indirect subsidies

Direct - lower price

ALPETCO - 23. not subsidy, not veto

Prevents state from unfair
competition.

Why should you get lower
price? Do you have a B &
Surplus capacity?

Customary in other contracts,
Lipton said: imaginative,

Risks

Near term:

1) Flood W.C. with crude oil
Lower in-value

Can't borrow money ^{from banks} if we don't sell
oil at profit

What if not done by 18 mos?

No big deal, ^{2 years} ~~many~~ be good for AK

#

BENEFITS

Employment
34 mil man hours

Sub contracts

Long-term risks:

plant built & running, fails,
it could happen to anyone,
not a function of contract

State doesn't have to do anything,
that it doesn't want to.

ACTION used to risks.

Endowment trust

Questions:

Miles: Subsidies, \$9 million for
line & tank fill, Ak not paid until
27 years.

Vote referendum makes it
clear that there may be a request for
a price change.

Hon. q: Will repay state, value on crude,
with interest, looked upon as an
investment of \$9 mil.

Miles: or subsidy for 27 years

Hon. q: Provision, if contract silent on lower
price, 3 parties could decide
upon price rather than 4. Strengthen
contract not weakens it.

Miles: Request is clear, real possibility

Chart: Page 5, Slide presentation,

What benchmarks can you take royalty
oil,

Hon. y: After attaining financing agreement
commitment for 1.5 billion

10.2. Se

Could 1.5 billion

Contract commits them to certain acts,

Chart: 30 mos, commence construction of
facility by, core refinery,
nothing else says plant must be constructed

Hon. y: No other commitments as to
configuration in contract

Attention:

AGO 559471

Only required to an in-state refinery
for 30,000 b/d for in-state.

4.2 aromatics obviously petrochemicals
olefins

Miles: Why isn't expenditure included
in contract? \$2.5 billion

All figures based upon \$2.5 billion,
benefits reduced.

Hon. g: Small Fewer jobs
Smaller for base

Pessimistic benchmarks

Gas contract

Chatterton: p. 40 Article 13

Can sell anything in excess
of the domestic needs

Hon. g: 30,000 b/d is not core refinery
large ~~more~~ needed complex needed to
making fuel products, if State

Henry

Less value added for ^{fuels} refinery, marginal
Shipping out \$30-40-50 / barrel.

Our economic benefit parallels State's desire.

Hiles: Are olefins and aromatics
restricted to

Ethane, from natural gas,

Full spectrum of products from
oil

90% of plants are oil-based

Rep. Miller: Paranoia,

Nothing says oil will be processed,
But after investment, we would want
to ~~make~~ process oil to its
highest value for profit.