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PETRO MARKETING SERVICES, INC.

TESTIMONY BY EARL JOHNSON

BEFORE THE

SENATE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

STATE OF ALASKA

May 11, 1978

P.O. BOX 7343 • TULSA, OKLAHOMA 74105 • (918) 747-5341

Senators.

Thank you for the opportunity to examine and discuss with you the pending Alpetco contract.

I have examined the Alpetco contract and numerous related reports, correspondence, news items and other data provided by the Committee.

The scope of my concern and my comments is essentially from the standpoint of effective crude oil marketing -- the area of my special expertise -- you have already heard a substantial amount of evidence on the viability of the proposed Petrochemical Facility, its effects on Alaska's economy, its risks and benefits to the state, and probably have well formed opinions on these matters.

The contract is well drawn, and does a good job of correlating a number of diverse elements into an understandable whole. There are, however, several philosophical elements that I feel need further consideration by your committee.

First, I cannot recommend the dedication of Alaska's royalty barrels to the proposed plant <u>until</u>, and <u>unless</u> the plant is completed. It certainly is absolutely necessary for any petroleum plant, especially one of the scope of the Alpetco project,

to have an assured, dependable, long-term raw material supply; but an otherwise viable plant requires such supply only when it is operational. Certainly a contract can be written which would guarantee the crude supply for such a plant when constructed, insofar as Alaska's present and future supplies of royalty oil are sufficient for such guarantees.

Absent some strategy for the use of royalty oil prior to plant completion that I have failed to consider, there appear only two ways in which Alpetco could benefit from pre-completion purchase of royalty oil. The most obvious benefit to Alpetco would be the outright purchase and resale for profit of Alaska royalty oil. Given present crude market conditions in the South 48 and existing government regulations, this appears unlikely. However, with an option to purchase up to 150,000 barrels per day at a price enabling them to reach West Coast ports with North Slope crude at a delivered cost to them under $12.40 per barrel (11.45 FOB Valdez + 0.95 transportation) and with the West Coast spot market at $13.00 per barrel or more currently, the opportunity is surely open for them to offer North Slope crude at substantially discounted prices and still retain a considerable profit margin. Whether they actually sold large amounts of crude at discounted prices or not, the market price for North Slope crude would probably be reduced in West Coast markets. There would be no offsetting increase in Gulf Coast markets so

that the net back on Alaskan royalty oil in value would be reduced. The foregoing situation, of course, is based on current circumstances. My original understanding of the contract was that Alpetco might selectively meet the required elements of 10.2 (1) through (3), especially 10.2(3)(d), very early after effective date, thereby advancing the triggering of paragraph 2.2, "Initiation of Deliveries," as early as 60 days after the effective date. Alpetco might then, it seemed to me, begin to take crude in the 9th or 10th month following the effective date. I have just read assurances from Mr. Honig and Governor Hammond that Alpecto would not take crude before the 25th month of the contract, and I find this reassuring.

My greater concern, however, is with the long term conditional dedication by Alaska of most of its known royalty oil. Certainly market conditions for North Slope oil today are discouraging and predictions to 1985 are pessimistic. It seems to me, however, that there are several possible ways that the market could change suddenly and unpredictably, that could greatly improve Alaska's potential for profitable in-kind marketing of its royalty oil. Alaska should weigh such possibilities very carefully before optioning its crude to others -- unless the benefits of granting such option are definite and substantial.

Some of the possible causes of "sudden and dramatic" market changes are (1) Disruption of foreign crude supplies-embargo, etc, (2) OPEC price increases, (3) Presidential imposition of a

fee on foreign oil, (4) Easing of prohibition on crude sales to Japan, and (5) More sympathetic federal regulatory treatment of North Slope royalty oil.

The second possible manner in which Alpetco might utilize pre-operational purchases of crude could be a time-trade arrangement with producers under which Alpetco would sell crude back to North Slope producers currently, in exchange for the right to buy similar quantities from the producers at a later date when it needs crude for actual plant operation. This appears less likely, however, than the resale of crude for profit by Alpetco.

With respect to market changes improving Alaska's in-kind profit potential, it will be argued that such changes would also affect the in-value price, thus increasing the price paid by Alpetco. This argument is valid unless such changes result in regulatory, transportation, or foreign exchange provisions that affect only royalty oil -- in which case in-value prices might not be affected. This would suggest some successful legal or political effort by Alaska to improve the present dissappointing price for its North Slope crude.

The issue of Alpetco's right under the contract to purchase crude prior to plant completion appears to have significant potential benefit to Alpetco, but such benefit seems to be

essentially unrelated to the successful promotion, construction and operation of the Petrochemical Facility. From Alaska's standpoint the possibility of being obligated to sell royalty oil without total assurance of the benefits calculated for successful plant operation would appear to be an indirect subsidy to the project, and could very well result in lower long-term net back to the State from its royalty oil sales. I believe that the concept of Alaska furnishing royalty oil to supply a plant such as Alpetco's is solid -- but only if the plant is one that can be financed and built based on its own economics, with the state agreeing to furnish the crude at competitive prices to supply the plant, beginning with its completion and commencement of operations.

I am still troubled by the lack of precise definition of "commit" and "commitment" as used in the contract, especially in Alpetco's benchmark requirements in paragraph 10.2. Again, Mr. Honig's letter of May 8, 1978, is somewhat reassuring in its statement that Alpetco's intended meaning of "commit to expend" means "contracturally binding agreements, contracts, and purchase orders." My remaining concern, however, is that in practice such agreements, contracts, and purchase orders are conditional, and subject to change or cancellation. Since the dedication of so much of Alaska's future production hinges on interpretation of the one word "commit," the legislature must at least assure itself of a firm and narrow interpretation by the commissioner with respect to all benchmark requirements.

There are a few technical concerns that I feel need comment. These are of less significance but should be considered.

1. The contract never states how much of the state's royalty oil will be utilized in the plant. Generally, the inference seems to be that if the plant is built, then it will process all of the royalty oil purchased. However, paragraph 4.3 is in direct conflict with that concept in that it provides, in part, "If buyer does not use the royalty oil sold and delivered hereunder or traded or exchanged oil in the Petrochemical Facility..." Indeed, if buyer does not use royalty oil or traded or exchanged oil, then what might he use, and with what effect on the State?

2. Paragraph 2.0 provides that seller shall have the right to use the remaining 15% of its crude in any way that it wishes, but paragraph 8.3 provides that state will sell "minimum" quantities of oil in value in order to provide for contract price determination. These two provisions contradict one another, and they raise the more important question -- how little crude can the state sell in value and thereby receive an accurate in value price in the contract? Are there restrictions on the minimum?

3. Paragraph 12.1: In providing for security interest credit protection for the state, I am compelled to comment that the procedures thereunder will turn out to be extremely

complex. As a crude seller, I would have much preferred the bond or L.C. concept. Additionally, is the $50,000,000 capital and surplus provision adequate for a bank to issue a letter of credit for, say, 60 days runs at 150,000 barrels/day at $6.00 per barrel?

4. Paragraph 15.2 (Force Majeure). Item (ix) provides that inability to obtain federal, state, or other government permits or licenses shall be regarded as a force majeure, and could hold the contract in limbo for up to four years (longer if state permits are the force majeure item). Presumably, Alpetco could be receiving royalty oil during any such delay.

In closing, I should like to state very clearly, that I would like to see the Alpetco project succeed -- for Alaska's benefit. My expressions of concern herein are genuine, and the result of my best effort to evaluate the contract as I see it -- from a crude oil marketing standpoint. Time for study and preparation has been short, and the subject is complex.

I shall be happy to answer questions directly or indirectly related to my testimony today -- either now or later, in writing.

PETRO MARKETING SERVICES, INC.

Supplementary Statement By

Earl Johnson

Before The

Senate Special Committee on Royalty Oil and Gas

State of Alaska

May 15, 1978

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Senators.

Since testifying before this committee on May 11, I have received and noted several items of additional information that I consider pertinent and highly significant -- enough so, in fact, to appreciably alter some of my attitudes toward the Alpetco contract as it pertains to royalty oil purchases. These changes also must affect my testimony and I should like to make the following brief statement prior to further consideration of the Alpetco matter.

Following my testimony on May 11, I discussed the Alpetco contract with Commissioner LeResche and Deputy Commissioner Boness, especially with regard to my testimony which opposed early taking of royalty oil. I characterized such early taking of crude by Alpetco as a probable indirect subsidy to the project by the State due to my visualizing an opportunity for Alpetco to purchase crude under the contract's pricing formula at a price which would permit them to discount North Slope royalty oil on the West Coast -- and still make a profit.

I found my discussion with Mr. LeResche and Mr. Boness very enlightening. Both of these gentlemen are exceptionally well informed both with respect to the subtleties of the Alpetco

contract and with respect to the crude oil marketplace generally.

In arriving at some of the conclusions outlined in my earlier testimony, I had used a weighted average price FOB Valdez of $11.45, based on the marketing of 2/3 royalty oil on the West Coast (and Valdez) and 1/3 on the Gulf Coast. These figures are essentially correct, but do not fully address the unique pricing mechanism in the proposed contract. This pricing mechanism contains a feature that substitutes the average point of delivery price of all of the other producers for the actual price of any producer whose actual point of delivery price is lower than the weighted average price of all of the other producers. This feature tends to protect the state from receiving a low price from Alpetco under any circumstance, but especially under those actual crude marketing practices now existing with respect to North Slope crude. Specifically, some 61% of North Slope Crude was marketed at Valdez and on the West Coast during March 1978, with the other 39% going to the Gulf Coast. The calculated weighted average price at TAPS inlet was $5.16 per barrel ($11.43 FOB Valdez). However, the pricing in the contract would set the Alpetco purchase price under the contract at $6.09 at TAPS inlet ($12.36 FOB Valdez). Since this would result in a delivered West Coast cost to Alpetco of approximately $13.25, there would obviously be no incentive for Alpetco to exercise its crude option -- and certainly no way to discount in the West Coast Market

(since the going rate for NS crude is approximately $13.00 per barrel at present.) This pricing anamoly results essentially from the fact that almost all of the crude going to the Gulf Coast is Sohio's. Their crude is thus priced at a weighted average $4.34 at TAPS inlet. Since the weighted average price of all other producers (excluding Sohio) is $6.09, this price is substituted in the pricing formula as the price per barrel for Sohio's crude in weight averaging all crudes. The foregoing prices are based on actual volumes and prices as reported to the State for March 1978. I have calculated additional simulated conditions for March and have concluded that even if Sohio commenced marketing an additional 100,000 barrels per day on the West Coast instead of the Gulf Coast, and Exxon and Arco each sold 50,000 more barrels per day on the Gulf Coast instead of the West Coast, the Alpetco price at TAPS inlet would still be $5.53 ($11.80 FOB Valez = $12.70 West Coast). Even this very substantial change in West Coast market balance between companies (which I do not regard as likely in the near future) would not produce a contract price low enough to permit Alpetco to discount significantly in the West Coast market and still achieve a profit on the sale of crude.

Because of this special pricing feature, the full import of which I had not realized at the time of my earlier testimony, I now believe there is very little likelihood of Alpetco's early taking of crude; and even less likelihood that if such early taking does occur (after 25 months), that the State

would be adversely affected as to price. In the light of my more complete information, I visualize the Alpetco's possible sales of crude on the West Coast would have no serious effect in the West Coast marketplace. I retract my earlier statement regarding the crude option to Alpetco constituting an indirect subsidy by the State to the Alpetco projects, since I have been convinced that the State is reasonably protected by the pricing clause.

The foregoing represents a substantial alteration in my testimony since last week. Briefly stated, I now feel much more comfortable about the crude dedication features of the Alpetco contract.

As earlier stated, I have been very favorably impressed with the grasp that your Royalty Commissioner and his staff have of the contract and its implications. Certainly, from the standpoint of the present administration attitude, one can feel assured that the bench mark requirements would indeed be rigidly and narrowly interpreted.

Thank you for the opportunity to amend my earlier testimony. My change of attitude about part of the contract is based on several hours of calculation based on actual March 1978 movements of crude as reported and an application of the Alpetco purchase price clause to these actual crude deliveries and modifications thereof.