

ALASKA LEGISLATIVE COMMITTEE / SUBCOMMITTEE 86/2

522 SCOMM16: JOINT SPEC. COMM. ROYALTY OIL & GAS 1977-78 522

SCOMM 16: JOINT SPECIAL COMMITTEE ON ROYALTY OIL AND GAS
1977-1978
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SCOMM

#16:1



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April 11, 1978

Ms. Elke Kallab, Project Officer
Alaska State Legislature
Division of Research Services
Pouch Y
Juneau, AK 99811

Dear Elke:

Enclosed are the answers to the challenging questions you sent to Battelle on March 8, 1978. We have answered questions 1a, b, & c, 2, 3a, b, & c, 4, 5, 7, & 9. In addition a discussion of "How are the entitlements regulations relevant to the ALPETCO refinery?" is included as question number ten. Questions numbered 6 & 8 were omitted as we agreed via previous telephone conversations.

The proposed contract with ALPETCO is primarily a legal document but includes considerable technical and economic content. Our review has been limited to the latter aspects and thus our responses in no way should be considered as a legal opinion.

While formulating our answers, we observed that the impact of several of these potential issues will be dependent upon ALPETCO's success in the crude oil markets. Thus, we believe that additional information should be obtained regarding ALPETCO's planned marketing strategy for crude received prior to refinery operation. For example, as we point out in our answer to question Number 3, the weighted average netback value may decline dependent upon ALPETCO's success in the West Coast crude market.

We have enjoyed working for you, Mr. Erickson, and the State Legislators. Battelle hopes that we have fulfilled your request and that we have provided information useful for formulating state royalty oil policy. If you have any questions regarding this work or our previous royalty oil study, please call either of us. We hope that a mutual relationship has developed and that we can provide additional assistance in the future. In the meantime, we will keep our ears to the ground for new developments that may be relevant.

Sincerely,

M. Clement, Principal Investigator

W. H. Swift, Manager
Alaska Projects

Attachments

AGO 545433 +

QUESTION 1a

How likely is it for ALPETCO to be able to adhere to the time tables set out in Article 10.2.

ANSWER

Article 10.2 of the proposed contract with ALPETCO lists nine major milestone dates extending from the contract effective date over a period of 72 months (6 years). Construction is to be initiated by Milestone 5 or 30 months (2.5 years) from the contract effective date. The wording of Article 10.2 includes reference to apparently non-cumulative 6 to 12 month time extensions so the longest extension period (12 months) controls at Milestone 9. Most of the milestones gage performance based on ". . . expend or commit to expend". There is no specific milestone for actual refinery startup so the construction period can exceed 3.5 years. Given the scale of the endeavor, we believe more than 3.5 years for the construction period will be required.

Although it is impossible to estimate the likelihood for ALPETCO to be able to adhere to the time table in any quantitative sense, it is possible to make observations regarding each of the milestones and some of the factors that will influence their being met on schedule.

Milestone 3 (18 months)

The most difficult aspects of this milestone refer to (1) entering into contracts for sale of 70% of the product output, (2) obtaining commitments for \$1.5 billion in loans or equity, and (3) completing and filing an Environmental Impact Assessment on the facility. Product sales contracts and financial commitments must to some extent be developed concurrently. This will require an intense marketing and management effort in an arena dominated by very large and experienced firms with worldwide operations. Success will depend on ALPETCO's being able to assemble a very strong team.

The completion and filing of an Environmental Impact Assessment is possible within this time period. Note however that this document would be in partial support of Environmental Impact Statements that will very likely have to be prepared by federal permitting agencies. It is these latter documents that may control timing.

Milestone 5 (30 months)

This milestone calls for definitive documentation of long-term funding and initiation of construction. Only one year is allowed from the filing of construction permit applications in Milestone 3. Since it appears likely that a number of federal permits, in addition to state permits, will be necessary, there is a strong possibility that NEPA procedures would have to be followed. These procedures call for agency preparation of draft Environmental Impact Statements and time for public comment. There is some potential vulnerability for ALPETCO in the NEPA process stemming from the need to evaluate the environmental impacts of alternatives. In addition, opponents to projects have increasingly used the argument that a project must justify the "need"--the need for electric power as an example. In recent years this argument has resulted in extensive and time consuming litigation.

Milestone 9 (72 months)

This milestone as worded does not actually commit ALPETCO to complete construction of the refinery by a certain date. However, if it is assumed that this is the intent, only 3.5 years are allowed for construction. Assuming modular construction techniques are employed to the maximum extent possible this may be feasible. However the risk of delay can be substantial considering the length of the construction season available.

QUESTION 1b

In your best judgment, what affect will the lack of assured supply of 150,000 bbl/day have on the implementation and successful completion of the contract?

ANSWER

It is apparent from most forecasts, that North Slope field (as presently known) production will be peaking and possibly on the decline at about the time the proposed refinery could reasonably be expected to come on-stream. If the proposed ALPETCO project is to be totally dependent upon proven North Slope royalty crude reserves, we believe investors would be extremely reluctant to commit funds according to the milestone schedules. The question then becomes one of judging what other sources of crude supply ALPETCO may be able to contract for or at least be able to point to with the degree of assurance necessary to satisfy investing financial interests.

Another complicating factor is the possibility of a decline in the surplus crude supply on the West Coast after 1985. If this surplus were to persist, ALPETCO presumably could purchase crude from SOHIO or other North Slope producers but probably under contracts with recall provisions. The other alternatives are reserves elsewhere in Alaska but yet to be discovered. Since an Alaskan refinery is out of the mainstream, it is unlikely that non-Alaskan crudes could be economically processed. ?

ALPETCO could argue that, under the Emergency Petroleum Allocation Act of 1973, the federal government could assure a supply. Whether this argument would carry any weight with the banking community is conjectural.

QUESTION 1c

What possible detrimental implications exist for the State if the construction and completion of the project were substantially delayed, particularly after initiation of interim crude shipments?

ANSWER

Two potential problems will probably occur if the completion of the project is substantially delayed. ① The first will be additional costs in the form of financing charges or interest on construction loans ② The second could be an inability to honor sales contracts which were entered into prior to the completion of the refinery.

- ① All delays will add to the cost of the refinery as the cost of capital (interest charges) is proportional to time. For example, assuming the refinery is financed with loans, the interest charges begin to accumulate as soon as the project is begun. In this case, interest charges began to accumulate with the proposal preparation. Each delay in the program will extend the time which these interest charges must be paid, prolongs the startup of the plant, and delays the recovery of all previous investments.

The time when the delay in the schedule occurs is also important. Early delays are not nearly as costly per unit of time because usually only a small fraction of the total investment is committed. Delays which occur later in the project will probably be more significant because a larger fraction of the total investment will have been made. At the same time these early delays may not be insignificant as interest on previous investments must be paid until the investment can be recovered via future cash flows.

These interest charges will not be insignificant. For example, assuming capital costs 10% and investments of \$1 billion, (estimated total project costs range from \$1.5 to \$2.5 billion) annual and daily interest charges will be \$100 million and \$274,000, respectively. Thus, a two day delay could increase the total project cost by a half million dollars. In summary, the result of these delays is twofold. Added interest costs increase the total investment and each delay in construction delays the opportunity to recover previously invested capital.

From the State's reference, the resulting problem associated with these delays is that each delay and added cost will diminish the competitiveness of the ALPETCO plant. Eventually, the delays and additional costs will become so great the plant will not be competitive without some form of subsidy. Thus, the State may find itself in a position where it will have to grant a price reduction for crude sold to ALPETCO or some other form of subsidy, or standby and watch the plant be closed.

- ② Project delays could also affect ALPECTO's ability to honor sales contracts; ie, deliver product as scheduled in sales contracts. Most sales contracts will probably have a date for product delivery and the first delivery should be as close to the plant completion date as possible.

These product delivery dates will be important to any sales contract entered into by ALPETCO or other petrochemical producers. ALPETCO's refinery will produce several basic chemical building blocks (benzene, toluene and xylene). These products will be incorporated into intermediate and finished products by plants operating downstream in the production process. Thus, the production schedule and sales contracts of ALPETCO's and their customers must be carefully coordinated as the downstream plant's production will be dependent upon ALPETCO's production or one of their competitors. Thus, ALPETCO will be forced to commit to delivery dates if they wish to enter into any meaningful sales contracts. Project delays which affects the delivery of these products could, therefore, be critical to ALPETCO's marketing plans.

No additional significant problems associated with delays after interim crude shipments are apparent; that is, shipments to ALPETCO prior to their completion of their refinery. Article VIII seems to provide the State with adequate protection and assurance that they will receive the same revenue per barrel as if they had elected the in-value option.

NOTE: Please see the answer to question 3 also for further information.

QUESTION 2

What hazard, if any, exists that the royalty oil which may be taken by ALPETCO prior to plant startup may disrupt the West Coast oil market?

ANSWER

The issue of whether ALPETCO could undercut the price of the North Slope producers marketing crude on the West Coast has been raised based on the observation of 1) the surplus of crude in PADD V and 2) the position of SOHIO in having to market a substantial fraction of this crude in the Gulf Coast market. The suggestion has been made that since ALPETCO will receive royalty oil at the weighted average price of the producers netbacked to the lease; theoretically, ALPETCO could undercut SOHIO on the West Coast down to \$10.72/bbl and bring all prices down in the process. Should this occur, there would be a substantial loss of royalty and severance tax revenues to the State.

A number of factors lead us to believe that although this outcome is theoretically possible, there a number of factors that suggest the likelihood is very low.

1. ALPETCO conceivably has two distinct West Coast markets for its oil. These are the independent refiners on the West Coast and Hawaii (671,000 bbl/day out of a total of 2,854,000 bbl/day capacity) and the major integrated oil companies.
2. The independent refiners are in general not equipped physically to process a major fraction of North Slope crude due to its higher yield of less desirable heavy products and higher sulfur content. Since their financial viability is marginal at best, capital improvement projects are unlikely. The independent refiners' very existence is largely due to the small refiners bias in the federal entitlements program.
In addition, the small refiners are dependent upon maintaining good buyer/seller relationships with existing producers and the major oil companies. (An example of this effect has been evident in recent past sales where only the larger (126,000 bbl/day

Martinez Refining) Lion Oil Company, an independent, was a purchaser of ANS crude (19,000 bbl/day). Thus, even if the independent refiners were capable of processing additional ANS crude, it seems unlikely that they would endanger relationships.

3. The on-shore pipeline systems for moving crude oil in California are owned and operated by the major companies and do not operate as common carriers. The industry has developed a policy, however, of allowing other firms to utilize the pipeline on an exchange basis. ALPETCO will, therefore, probably be allowed to use the pipeline system, but it will require a contractual arrangement with mutual benefits.
4. For the above three reasons, we conclude that the PADD V independent refiners are not a likely market for ALPETCO's crude.
5. The motivations of the major oil companies are quite different. As integrated oil companies, they will resist any action that would destabilize the crude market and lead to price cutting. This is apparent in the recent market behavior as SOHIO has been burdened with the costly transport of ANS crude to the Gulf Coast and resisted measurable price shaving. In addition, ^{SOHIO} they are probably not motivated to assist entry of a new West Coast refinery through their actions.
6. Unlike the major oil companies, ALPETCO lacks the crude and product exchange flexibility that apparently is assisting marketing of ANS crude to the major refiners on the West Coast; e.g., Chevron's (minor North Slope interest) recent purchases displacing foreign imports to the Gulf Coast. In this regard, ALPETCO would be in the same position as the State were the latter to take its royalty in-kind and attempt to market it.
7. In summary, it appears that ALPETCO will be forced into the Gulf Coast and interior markets with little opportunity for price cutting occurring on the West Coast.

In addition, if ALPETCO assumes the burden of marketing the royalty fraction and must do so east of the Rockies, this reduces some of the burden on SOHIO for clearing the surplus. The net effect would be an increase in the net back for SOHIO and hence, the weighted average net back for purposes of computing royalty and severance revenues.

As will be pointed out in the answer to question 3, ALPETCO's entry into the West Coast market could reduce the netback price for at least some of the producers. Therefore, it seems unlikely that they will enthusiastically welcome ALPETCO on the West Coast.

The question raised by Dr. Arlon Tussing in his testimony before the Special Committee on Royalty Oil and Gas can be approached in another way. Dr. Tussing suggests that the producers of North Slope crude are exercising market power. The pricing behavior of SOHIO and Exxon is consistent with the monopoly hypothesis. Combined, Exxon and SOHIO control 73% of the Prudhoe Bay productions. ARCO has another 20% which it uses in its own refineries on the West Coast. Thus, nearly all of the North Slope sold on the open market is produced by two firms. The overall market price is determined by OPEC; however, within this pricing limit there is the potential for market power. This, as Dr. Tussing points out, may not be contrary to the best interest of the State of Alaska.

SOHIO and Exxon are selling ANS crude in California and in the Gulf Coast markets at substantially different "netback" prices. To the extent that the market continues to perform in this fashion, the State of Alaska royalty income will be greater by virtue of the higher prices on sale made in California or in any other location where the price is above the marginal cost of production and transportation.

The question then becomes whether ALPETCO will break the monopoly position of the current producers. It is doubtful that ALPETCO's entrance would do this for two reasons. First, the amount of oil involved in reality is quite small; second, it is not clear that ALPETCO has a strong incentive to engage in a price war. One must remember that ALPETCO's entrance into the West Coast oil market will not increase the supply of oil available. It will simply redistribute it from the present producers to ALPETCO. Most of the oil ALPETCO receives could, in theory, be sold to the same parties with whom the present producers are now dealing. Their relative inability to make exchanges would limit this to some extent.

The cost of the oil to ALPETCO will be greater than the netback price on sales to the Gulf Coast as long as the producers are selling to the California market at a higher price. If the price in both markets were driven to the same level, then ALPETCO could no longer operate as a broker for the royalty oil as its acquisition cost of crude would be the same as the going market price and ALPETCO would be unable to recover any of its marketing costs. Thus, ALPETCO can only make interim crude oil sales if the California netback price remains above the Gulf Coast price. Further ALPETCO's motives are no different than those of SOHIO or Exxon -- they will attempt to maximize their profits. To do this ALPETCO must avoid triggering a "price war" in the West Coast market.

While it is possible that ALPETCO's interim oil sales could force the West Coast netback price down to Gulf Coast netback price, it is unlikely to happen. ALPETCO in the near term has little incentive to break the price structure on the West Coast. However, any oil previously sold by the producers on the West Coast, which would be forced into the Gulf Coast market, will reduce the average netback price as calculated in the contract. (For a discussion of this point, see question 3.)

QUESTION 3

Please review the provisions governing the price to be paid by ALPETCO (Article VIII), and comment on the actual effect of the calculation method contained in Exhibit "B".

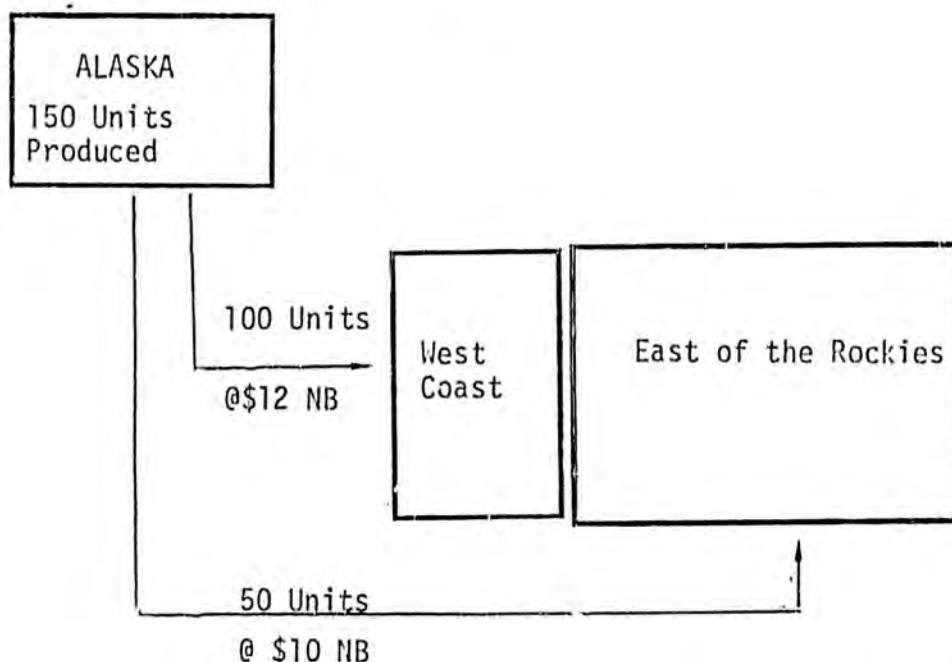
ANSWER

The pricing provisions of Article VIII and Exhibit B call for calculation of a net back price based on evaluation of all producers prices. ALPETCO must pay the State the highest price calculated using the sequence exemplified in Exhibit B.

As discussed in the answer to Question 2, we do not feel that ALPETCO will be able to market crude oil received prior to plant startup on the West Coast. However, if they are able to do so, the net effect will be to reduce the net back price paid the State under Exhibit B. This situation arises from the limited ability of the West Coast refineries to absorb additional North Slope crude. If ALPETCO succeeds in marketing one-eighth of the production on the West Coast, the overflow burden to the producers will be increased by their need to market a larger quantity east of the Rockies. This situation is diagrammed in the following two cases using arbitrary values.

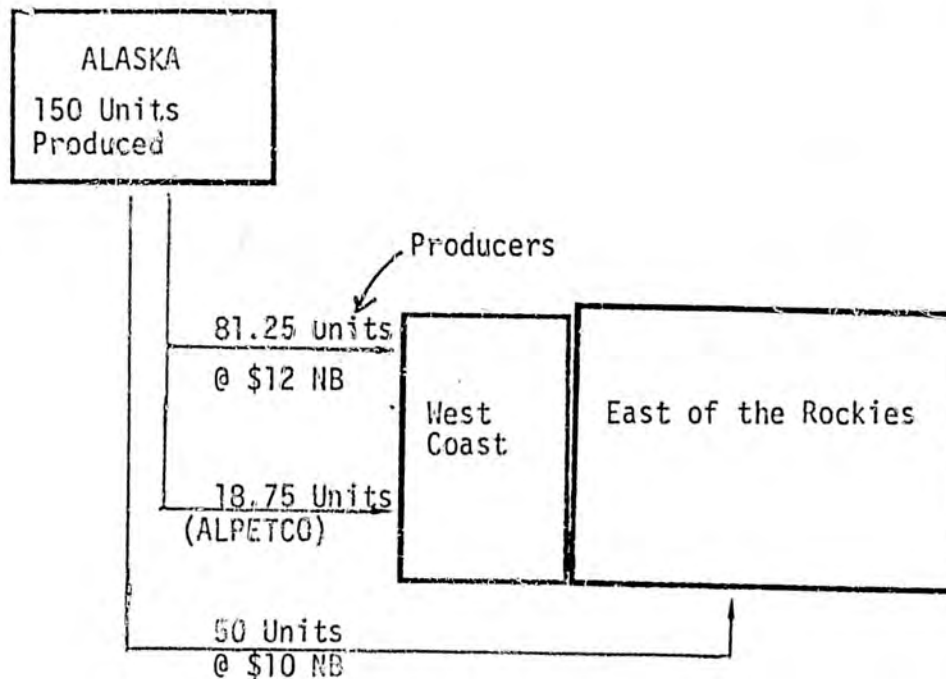
variation of
Arden's
theory

CASE A: ALPETCO Not Marketing Crude on West Coast



Weighted Average Net Back \$11.33

CASE 8: ALPETCO Markets One-Eighth of Production on West Coast



Weighted Average Net Back \$11.23

reduced

Although the above cases are hypothetical, it is apparent that ALPETCO's marketing situation can significantly impact the State's revenue. The potential effect is also significant in regard to Question 1-c.

QUESTION 3a

Under what circumstances can you envision the State offering future royalty oil for less than what ALPETCO is required to pay for Prudhoe Bay royalty oil as covered in Article 2.3 and is it likely to happen? (This, of course, assumes such royalty oil becomes available for sale.)

ANSWER

Presumably the State could offer future royalty oil for less than what ALPETCO is required to pay for Prudhoe oil if such future royalty oil had an in-value price less than that for Prudhoe Bay oil. This condition would occur for new oil discovered, produced, and taken in-kind in ^{less} ~~more~~ remote regions than the North Slope resulting in a lower point of delivery price. However, ALPETCO would be interested only if their net refinery gate price would be lower taking into account additional transportation costs and any differential entitlements treatment. Such oil might be from new discoveries on the North Slope with additional transportation costs to TAPS Inlet and would, most likely, be priced under conditions similar to Prudhoe Bay oil. In this case, ALPETCO would be indifferent as long as 145,000 B/D of the latter oil is available as royalty.

Another circumstance could occur, say for a discovery in Bristol Bay, on state leases and under federal new oil price regulations. Under these conditions, ALPETCO might be able to receive oil at its refinery at a cost less than Prudhoe. (See answers to 3b and 3c.)

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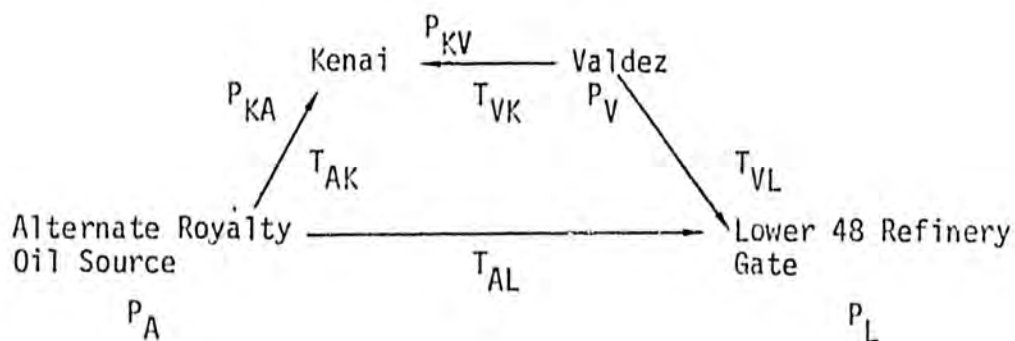
QUESTION 3b

Article 2.3 of the contract gives ALPETCO an option to purchase up to 90% of any oil that is sold or offered by the State at a price lower (taking account of transportation costs) than the price paid by ALPETCO under this contract. Given your knowledge of Alaska's oil markets, what is your assessment of the probability that circumstances which would bring this section of the contract into effect will actually occur?

ANSWER

Article 2.3 refers to royalty oil (taken in kind) other than that produced from the existing Prudhoe Bay leases. Presumably additional royalty oil could come from new leases on the North Slope, other state lands, and from the inner continental shelf. The article contains provisions relating to adjustment for transportation costs from the Prudhoe lease and the alternative sources of royalty oil.

Several circumstances could develop that would result in Article 2.3 coming into play. The first circumstance can be diagrammed as shown below and the conditions developed through the following calculation:



In the above diagram

- P_L = the lower 48 refinery gate price of ANS crude
- T_{VL} = transportation cost from Valdez to lower 48 refinery
- T_{VK} = transportation cost from Valdez to Kenai
- T_{AK} = transportation cost from alternate source to Kenai

T_{AL} = transportation cost from alternate source to lower 48 refinery

P_V = price at Valdez = $P_L - T_{VL}$

P_A = price at alternative = $P_L - T_{AL}$

P_{KV} = price at Kenai from Valdez = $P_V + T_{AK}$

P_{KA} = price at Kenai from alternate = $P_A + T_{AK}$

If P_{KA} falls below P_{KV} , ALPETCO could invoke Article 2.3; i.e., if

$$P_{KA} < P_{KV}$$

or

$$T_{AL} - T_{AK} < T_{VL} - T_{VK}$$

This situation could readily come about if .

- 1) another source of royalty oil became available with favorable transportation costs (a new state Cook Inlet lease for example),
- 2) the State chose to take the royalty in kind.

② A second circumstance would arise for sale of royalty oil taken in kind that falls in the federal lower tier regulated category; e.g., Cook Inlet oil. An exception is for the current contract with Tesoro and renewals of that contract.

③ A third circumstance could arise if other new discoveries made in Alaska are not allowed the special pricing treatment given the North Slope oil under federal price regulation; e.g., a new discovery might be limited to the upper tier price.

QUESTION 3c

Article 2.3 allows ALPETCO to reduce their purchases from Prudhoe Bay by the amounts purchased (presumably at lower cost) under Article 2.3. One implication of this provision may be that the State, at a future date, may be able to grant a subsidy to ALPETCO merely by offering oil from sources outside of Prudhoe Bay at prices below market value. What other implications, if any do you see in the operation of 2.3?

ANSWER

Conditions can be hypothesized such that the State of Alaska might be willing to accept less than market value for their royalty oil. For example, if the State desired to stimulate economic development with low cost energy (crude oil), then royalty crude oil might be offered at less than market value. (At the same time, it should be pointed out that the State always has the option of accepting their royalty "in-value" and therefore, does not need to accept less than fair market value for their royalty oil if revenue is their major objective).

Given that the State elects to sell their oil at less than market value, then all firms (third parties) would be offered the oil at the reduced price. ALPETCO could then gain access to this lower priced oil by exercising their option according to Article 2.3. ALPETCO would probably then reduce their purchase of Prudhoe Bay crude and replace it with oil outside of Prudhoe Bay if the delivered price (including transportation costs, etc.) for this crude were less than the price for Prudhoe Bay oil. (ALPETCO would also have access to the oil outside of Prudhoe Bay if the Prudhoe Bay oil deliveries fall below 145,000 bbl/day via Article 2.4.)

A significant point of this discussion is that State revenues from oil sales should be the same independent of ALPETCO's action with respect to Article 2.3. Once the State makes the decision to reduce the price of its oil, the State will receive less revenue per barrel. The revenue will, however, be the same if ALPETCO buys the crude at the lower price or a third party buys the oil. Thus, it seems the State should look upon the reduced price as a subsidy to all potential purchasers and not just ALPETCO. The reduced price can be interpreted as a subsidy, however, as the State could receive the market value by accepting their royalty in-value.

The review of potential subsidies via Article 2.3 has revealed one broader implication. Once the price reduction for non-Prudhoe Bay oil is in place, other pressures will probably result. For example, if the State reduces the price of any royalty oil to stimulate economic growth, one can hypothesize that pressure will build encouraging the State to take all its royalty oil in-kind and sell it at a reduced price. After all, if it's good to sell some of the State's oil at a reduced price and offer some firms a subsidy, the State should be better off if it sold all its oil at a reduced price, including Prudhoe Bay oil. Alternatively, the State might be pressured to reduce the price of all oil slightly as opposed to granting a larger reduction on its oil outside of Prudhoe Bay. The smaller price reduction would seem to be more palatable as no one would find themselves in a relatively worse position because of the State's actions; ie, that is, all consumers of the State's royalty crude would receive an equal subsidy. ALPETCO would then not be as concerned about non-Prudhoe Bay oil if the price of all State royalty oil were reduced equally.

? that's not rational

? why? not

The impact of any price reduction has to be a reduction in State revenues assuming no increase in sales volume. ALPETCO's utilization of Article 2.3, however, should not change the State's revenues once the price concession has been granted. The State will receive the same revenue per barrel from ALPETCO as it would from any third party if ALPETCO did not exercise Article 2.3. Thus, the total revenue will be less because of the reduction in price, but the revenue should be the same if ALPETCO exercises its option according to Article 2.3. The only difference in revenue will occur if the State cannot find a new market for any Prudhoe Bay royalty oil turned back by ALPETCO. This may indeed present a problem for the State as the Prudhoe Bay oil will be higher priced and probably available in only small quantities. Of course, the State always has the option of taking its royalty in-value which eliminates the need to market the Prudhoe Bay royalty oil not taken by ALPETCO.

? why? a problem?

3

In summary, Article 2.4 appears to provide ALPETCO with some reasonable protection while probably resulting in no loss in State revenue. Basically, the clause will prevent a competing firm from moving into Alaska and obtaining royalty crude at a wellhead price less than ALPETCO is paying. This type of clause, a right of first refusal, is only prudent business practice on ALPETCO's part and is usually desired by most firms.

Furthermore, ALPETCO will maintain they took the initial risks and, therefore, should have the first chance at any future opportunities that become available; e.g., lower priced crude oil. At a minimum, they will expect some benefit from being the State's first customer and certainly not compromise their position relative to future competition. It is rather apparent that any price concession to a third party not available to ALPETCO would result in penalizing ALPETCO. Thus, they desire the right of first refusal or Article 2.3.

QUESTION NO. 4

Will the power requirements of the facility (assuming it is located on the Kenai Peninsula) create any spillover costs or benefits to other power users in southcentral Alaska?

ANSWER

ALPETCO, in their October 15, 1977 proposal, does not explicitly state the power requirements for the refinery except by the reference: ". . . . The power generation facilities alone would supply a normal city of 60,000" Assuming Alaska conditions, we estimate this amounts to a power plant capacity of about 80 MW. This value is comparable to one that can be derived from Alaska Petrofining Corporation's proposal and appears reasonable.

ALPETCO'S proposal (Section 7.3) states that "Power requirements for construction and the operation of the refinery will be self-generated with backup emergency facilities provided. ALPETCO will be able to supply emergency power to the community through a tie-in to the local power company if necessary"

At the present time the Kenai Peninsula has 67.11 MW of installed capacity of which 5.8 MW are standby internal combustion units and 9.7 MW is industrial self-generation (Collier-Kenai). A 115 kV transmission line ties the Kenai system to the Anchorage area and at maximum conductor size could deliver ~50 MW.

Assuming ALPETCO proceeds with its plan to provide its own generating capacity and an emergency intertie to the Homer Electric Association system, it appears that some reliability benefits would accrue to the southcentral power system.

ALPETCO's proposal implies that refinery fuel will be self-produced as is common practice. However, under the coal conversion provisions of the probable national energy policy, this may not be possible. The alternatives are coal by rail (extension required) from the Nenana field or by barge from a newly opened Beluga field. Steam requirements for process heat and power generation are indicated by ALPETCO to be 5.5 million lbs/hr. The coal requirements at this level amount to 3-4 million tons/year. This rate is probably in excess of a feasible mining rate in the Nenana Field but approaching the mining rate necessary to support a major export mine at the Beluga Capps Field with associated railway to tidewater and loading pier.

A substantial development at Beluga would be required over and above the possible 2-200 MW CEA plants under consideration for 1984 and 1986. The State may wish to question ALPETCO as to their refinery fuel plans.

QUESTION 5

Under Article 2.4 of the contract, the state will be committing up to 70% of otherwise uncommitted non-Prudhoe Bay royalty oil to fill out any shortfalls in the 150,000 barrels per day which ALPETCO needs. Since it is almost certain that royalty oil from Prudhoe Bay will fall far short of the 150,000 barrels per day, this provision seems to sharply reduce our options with respect to disposal of any royalty oil which might become available in the future. Presumably, market conditions and other factors may change substantially between now and the time that this option is exercised. Taking into account the pricing provisions in Article 8.1 (and exhibit "B"), what is the likelihood that we would be able to get a better deal in the future if we weren't bound by this option?

ANSWER

Clause 2.4 of the contract will probably reduce the State's options regarding royalty oil which might become available in the future. The reduction in the State's flexibility may occur, if other royalty oil becomes available, when the North Slope royalty oil is less than ALPETCO's requirements and if a third party desires the new royalty oil; this also assumes ALPETCO constructs and operates its proposed plant. The real question is to what degree will the State's options be diminished and what opportunities will be foregone because of Clause 2.4? In terms of lost or foregone revenue, we believe very little, if any, will be lost. The primary potential loss will be the freedom to enter into unconstrained marketing contracts, but these future contracts will only be needed if several conditions occur (e.g., new large discoveries of crude and rapid growth in petrochemicals markets which could support a second Alaskan plant).

Similarly, market conditions will change with time and possibly the State may be able to arrange a "better deal" in the future if the State were not bound by Clause 2.4; e.g., attract a second plant. The probability, however, that a significantly better deal could be arranged seems slight. The contract has several clauses to protect the State's interests and to assure that the State does not forego any potential revenue. (Admittedly, a second plant will provide benefits in addition to revenues, but consideration of these benefits is beyond this work.) Specific reasons to support these conclusions are provided below.

The primary loss or opportunity cost associated with Clause 2.4 may be the potential loss of an opportunity to lure a second firm to Alaska. This assumes the State would be able to attract a second firm with their crude oil supply, but will not have a sufficient supply to satisfy ALPETCO's needs and at least partially satisfy the needs of a second firm. Given the experience associated with attracting the first firm (ALPETCO) and uncertain petrochemical market conditions, the probability of attracting a second firm to Alaska seems rather low at this time. On the other hand, if there is a need for two refineries and the economics prove attractive, the producers could build the second plant, produce the desired products in Alaska, and ship less of their crude to the West Coast of the lower 48 where a significant surplus will prevail at least through 1985 and probably beyond.

ALPETCO will probably exercise their option and request that the State allow them to purchase royalty oil in addition to the Prudhoe Bay royalty oil, assuming additional State royalty oil is available. This contractual option (to fill out any shortfalls in ALPETCO's need of 150,000 B/D) will definitely limit the State's options for disposing any royalty oil which may become available in the future. Again, the question is a matter of degree, ie, will the State be severely limited, and if so, how? For example, the State will not be able to offer an assured supply to another firm unless a substantial new oil discovery occurs on State lands. At the same time, the State's revenue should be essentially the same regardless of whether ALPETCO exercises its option regarding "otherwise uncommitted non-Prudhoe Bay royalty oil to fill out any shortfalls in the 150,000 B/D" potentially required by ALPETCO. Several clauses in the contract were identified which should protect the State's future revenue and assure that it will be essentially the same whether ALPETCO exercises its options, buys other royalty oil, or a third party buys the State's royalty oil. The clauses (8.1.3) are:

"The price of oil sold pursuant to the provisions of Article 2.4 shall be the greater of: (i) the best and highest price offered by a bona fide offerer for a like quality and quantity of crude oil to be produced from such lease out of which oil is being delivered; or (ii) a price equal to the sum seller would have received from its lessee or lessees had seller received its royalty in value instead of taking the quantity of royalty oil delivered hereunder as its royalty in-kind (amounts)."

where does the quote end?

In addition, the price shall be computed in accordance with Exhibit 8. The Buyer will also reimburse "Seller's pro rata share of (i) any basic sediment and water removal cost if seller is required to pay such cost as a result of seller's election to take its royalty oil in-kind; and (ii) any other direct cost reasonably incurred by seller had the seller taken its royalty in-value rather than in-kind." These clauses apply to ALPETCO and any third party and seem to give the State reasonable assurance that it will receive the same revenue whether or not ALPETCO exercises its option for non-Prudhoe royalty oil. In addition, analysis completed in Battelle's Royalty Oil Market Study found that the State's revenue was always greater with the in-value option than the in-kind option for oil marketed outside of the State. The previous two clauses regarding highest offer or revenue equal to in-value revenue seem to assure that the State will not lose any potential revenue as a result of contractual clauses granting ALPETCO the previously described option. Any loss incurred is more one of control and influence over future marketing contracts while the opportunity costs seem negligible if any occur. The loss in control and influence are essentially intangible and cannot be measured against the benefits of a potential in-State sale to ALPETCO. (The in-State sale will increase the State's revenue by \$0.90 to \$3.00 per barrel dependent upon where the oil would have to be marketed and the associated transportation costs.) Assuming the oil is not sold to ALPETCO, the clause providing them the option to purchase non-Prudhoe royalty oil should give ALPETCO a more assured supply and in turn aid them in obtaining financing. Also these options are frequently offered to the firm which incurs the initial risk. This "right of first refusal" provides them with an incentive to begin the project and also to protect them from future competition in a market that may not be able to support two large firms.

QUESTION 7

Under Article 4.3, ALPETCO is required to construct a facility that will be capable of producing 30,000 bbl/day of energy fuels for "intra-state domestic and industrial needs". In light of the probability that the full 150,000 bbl/day of royalty crude will not be available, what is the likelihood that ALPETCO would leave this capacity idle in order to maximize petrochemical product output? (Presumably ALPETCO could conceivably devote all production to petrochemicals even if they did get the full 150,000 bbl/day of royalty or other source oil.)

ANSWER

ALPETCO should not prefer to have any portion of their plant idle. After they have made the investment in the facility, they should attempt to operate at full capacity; ie, 150,000 bbl/day of crude. If ALPETCO cannot obtain the full 150,000 bbl/day of crude from the State, then they will have a strong incentive to buy crude from other suppliers. Crude should be available from producers such as SOHIO. The product from this production should be petrochemicals equivalent to 120,000 bbl/day and energy fuels equivalent to 30,000 bbl/day for a total of 150,000 bbl/day of crude oil requirements.

Given a case where ALPETCO may not be able to obtain the full 150,000 bbl/day of crude oil requirements, ALPETCO may still wish to produce the energy fuels for the instate market as opposed to maximizing production of petrochemicals at the expense of energy fuels. Two reasons for this are that energy fuels will probably be consumed within the State and, therefore, less transportation costs will be incurred. The second reason is that production of energy fuels via the ALPETCO plant should be considerably less costly than petrochemicals. The result of this is that energy fuels should be at least as profitable, if not more so, than petrochemicals. (Of course, the absolute profits for each product will be dependent upon the allocation of cost between the two plants, the operating efficiencies of each plant, the eventual price for each product produced, etc. None of this data is available now, so a precise evaluation is not possible.) Given the assumption that energy fuels are at least as profitable, then ALPETCO should maximize production of energy fuels and produce up to an equivalent of 30,000 bbl/day of crude assuming they can market their products.

Assuming ALPETCO constructs a 30,000 bbl/day energy fuels plant, they will probably produce all the energy fuels they can market. Based upon the straight-run design specified in their proposal, ALPETCO's energy fuels plant should be competitive in Alaska. Even if the plant is not profitable in Alaska, ALPETCO will probably produce as much as they can market after the plant is constructed. Once the plant is constructed, their investment is a sunk cost and the only way they can recover their investment is to operate the fuels plant. They should operate the plant as long as they can sell their product at a price which is greater than their variable costs; this will allow them to recover a portion of their investment each time they produce and sell another unit of energy fuel.

In evaluating ALPETCO's option, Alaska's future demand for energy fuels and current production capacity was examined. Existing refineries can produce 82,600 bbl/day; ie, Chevron at 22,000, Tesoro at 38,000, and North Pole at 22,600 (excluding the ARCO North Slope refinery of 13,000 bbl/day). After the ALPETCO plant is completed, the State will have a refining capacity of 112,600 bbl/day. A forecast of demand prepared by the Institute of Social and Economic Research, University of Alaska, February 1978, provides a liberal projection for petroleum liquids. The demand in 1976 was equivalent to 62,100 bbl/day (see Table 1). This demand is projected to grow to 112,600 bbl/day in about 1987 which is equivalent to Alaska's refining capacity assuming the ALPETCO plant is constructed. Thus, some of ALPETCO's production may be surplus to the State's needs and have to be exported to the lower 48 during the early years of ALPETCO's plant, if the projected demand for product turns out to be overestimated.

TABLE 1. Demand for Petroleum Liquids^{1/}

	<u>1976</u>	<u>1980</u>	<u>1985</u>	<u>1987</u>	<u>1990</u>	<u>2000</u>
Million Barrels of Crude Oil Equiva- lent per Year	22.7	28.5	35.2	41.1	46.9	81.2
Thousand Barrels of Crude Oil Equiva- lent per Day	62.2	78.1	96.4	112.1	128.5	222.5

1/ Institute of Social and Economic Research, University of Alaska, Energy Intensive Industry for Alaska - Phase I, pp. D22 & D36, February 1978.

? why?
need not
operate
at 30M;
rather
put it
into
petro-
chemical
production!
cheaper
to market
fuel via
export?

ALPETCO will probably never devote all production (150,000 bbl/day of crude) to petrochemicals assuming they receive the 150,000 bbl/day of crude from the State. The basic reason for this is a design constraints. The design of the ALPETCO plant specifies crude requirements of 150,000 bbl/day and energy fuel production of 30,000 bbl/day leaving an equivalent of 120,000 bbl/day for petrochemicals production. This essentially fixes the maximum equivalent daily production of petrochemicals at 120,000 bbl/day of crude. Additional capacity would have to be designed into the plant if production is to be significantly greater than 120,000 bbl/day. This additional capacity is too costly to include, or at least not a good allocation of funds, if it is not to be utilized routinely; i.e., if they plan to produce 150,000 bbl/day of petrochemicals per day they need a plant of this capacity and not a plant with 120,000 bbl/day capacity. Similarly, they would attempt to secure an appropriate volume of crude oil as feedstock.

QUESTION 9

What are the implications of requiring all future contracts to contain a provision which gives ALPETCO the paramount right to receive up to 70% of available royalty oil which is or could be taken in kind as far as volume and financing is concerned?

ANSWER

The apparent implication of Article 2.4 is that all other crude oil purchase contracts between the State and third parties will be subservient to ALPETCO's needs. According to this Article the State must allow ALPETCO to receive up to 150,000 barrels per day. Only after the State has satisfied ALPETCO's crude oil requirements is it free to supply royalty crude to third parties. Thus, supply contracts, if they exist, will be dependent upon ALPETCO's needs and also interruptable if necessary to satisfy ALPETCO's needs. The apparent result is that contracts of this nature will be somewhat less attractive to third parties.

This right in the proposed contract (Article 2.4) is intended to strengthen ALPETCO's position in seeking financing for the project and hence, strengthening the probability of success of the project. However, the clause does appear to restrict the flexibility the State would have to react to possible future changes in the crude oil market situation. An example (and possibly an extreme one) would be a lift of the prohibition on the export to Japan.

Reviewing the contract today, however, indicates that Article 2.4 is only a potential limitation and is perhaps a small concession to assure the consummation of a contract with ALPETCO. For example, before Article 2.4 limits the State in anyway, numerous events must occur. Some of these are:

- ALPETCO must build and operate its refinery,
- Oil must be discovered and produced on State lands outside of Prudhoe Bay, and
- A third party must desire the State's royalty oil outside of Prudhoe Bay.

In addition, the State has restrictions limiting ALPETCO's purchases of State crude to 150,000 barrels per day. They must also pay a price equivalent to the in-value price or the best and highest price approved by a bona fide offerer for a like quality and quantity of crude oil as dictated by Article 8.1.3. These conditions will temper the apparent impacts of Article 2.4 and insure that the State receives essentially the same revenue independent of the purchaser.

QUESTION 10

How are the entitlements regulations relevant to the ALPETCO refinery?

ANSWER

If the ALPETCO refinery were operating today, all North Slope crude it processed would receive an "entitlements benefit" amounting to \$2.01/bbl. This amount does not include any special entitlements treatment such as the small refinery bias since the Economic Regulatory Administration (ERA) must make an individual determination of eligibility. If the 30,000 bbl/day fuels refinery were treated separately from the rest of the facility, the small refinery bias would be significantly greater for the ALPETCO plant. The per barrel value of the small refinery bias for a 30,000 bbl/day refinery is approximately \$0.90 and \$0.10 for a 120,000 bbl/day refinery as opposed to \$0.05 for a 150,000 bbl/day refinery. Under the prevailing rules, separate treatment of each facility would produce incremental refinery revenues of \$31,500/day when operating at full capacity.

Presently, no refined product exports are being made; thus, there have been no ERA rules established on the right of a refiner to earn entitlements credits on crude refined for export. The current situation in California with respect to the excess supply of residual fuel oils has prompted the ERA to investigate the ramifications of exporting refined products. In that process, a precedent will be established regarding the entitlements treatment of crude refined for export.

The last entitlements regulation, which is uncertain at this point, is the special provision for California refineries. At the present time each barrel of ANS crude refined in California receives an entitlement credit valued at \$1.34; that is, \$0.67 less than the credit to ANS crude refined outside California. However, the ERA is in the process of changing the California provisions. One likely outcome will be to spread the special lower tier California oil credit over all imported and ANS oil refined in the U.S. rather than just the foreign and ANS crude processed in California. This will give an equal credit to ANS crude refined in the Gulf Coast States and in California.

One should keep in mind that the entitlements program may be phased out by some form of a Crude Oil Equalization tax. But given the large subsidy to small refineries present in the entitlements program, it is highly probable that a small refinery subsidy will be continued even after the entitlements program is dismantled. Whether it will be as extensive as the current program remains to be seen.

STATE OF ALASKA THE LEGISLATURE

FOUCHY - STATE CAPITOL
JUNEAU, ALASKA 99811
907 465-3800

You have asked that we prepare a memorandum for you outlining the possible subsidies/liabilities contained in the ALPETCO contract as they have been raised in public hearings to date.

I. Subsidies

Essentially, the administration is correct when it maintains that the contract is free of subsidies. Items which could be considered subsidies--in the broadest sense of the word--are listed below.

A. Price Reduction

A potential subsidy exists under Article 22, which allows Article 8 (Price) to be amended by reducing the in-value price ALPETCO has to pay the State. This is a potential subsidy, which several witnesses felt would come to pass.

B. Breaking of West Coast Pricing Mechanism

Arlon Tussing testified at length how ALPETCO could obtain a price "subsidy" for Prudhoe Bay royalty oil. He outlined how ALPETCO could break the West Coast market by selling the interim crude to which they become entitled on the West Coast at a substantially lower price than the established West Coast price, thereby reducing the value the State would be receiving for its royalty share. Furthermore, this subsidy could be prolonged and intensified by ALPETCO if ALPETCO continued to market part or all of the Prudhoe Bay royalty oil on the West Coast after the petrochemical facility comes on stream, instead of using it as feedstock. Even if ALPETCO were to utilize its supply of royalty oil in the petrochemical facility after it becomes operational, Mr. Tussing felt that it would be very difficult to return the price of crude oil on the West Coast

to its former high level. Again, the State would grant ALPETCO a subsidy, since the value of the oil on which the State receives its royalty would be reduced.

C. Pipeline Fill

You already pointed out that a subsidy of sorts exists under Article 2.6 by virtue of the State agreeing to provide ALPETCO with pipeline fill and storage tank bottom requirements for the life of the contract at no cost to ALPETCO until the expiration of the contract. The amount of money involved has been estimated to amount to approximately \$9,000,000.

D. Article 2.3

The question has been raised repeatedly if Article 2.3 constituted a subsidy. A subsidy would exist if the price of future royalty oil, which would be made available by the State, would be ~~offered for~~ less than ALPETCO would be required to pay under Article 8.1, and ALPETCO were to exercise its option under Article 2.3 and purchase up to 90 percent of such crude. However, it should be noted that this subsidy would apply equally to all bidders, not just ALPETCO, although ALPETCO would have first option. If the State refrained from offering future royalty oil for less than in-value price, it is unlikely that this option could ever come into effect.

E. Costs to the State

Commissioner LeResche listed several costs which would be imposed on the State as a result of approval of the ALPETCO contract. Whether they should be included as subsidies is questionable, but they do represent costs the State would not have to incur if the State were to continue to take its Prudhoe Bay crude in value.

The added administrative costs listed by Commissioner LeResche included:

1. Monitoring the contract.
2. Helping in the site selection.
3. Added accounting work as a result of taking our royalty share in-kind.
4. Litigating the question of free storage rights under the leases.
5. Processing and approving permit applications.
6. Measuring and testing of crude oil.
7. Obtaining crude assays.
8. Helping in designing the training and resident hire programs set out in the contract.
9. Implementing and monitoring those programs.

In addition, we would add the costs incurred by State personnel under Articles 5.3, 5.4, and 8.2. While litigation under Articles 5.3 and 8.2 may be at ALPETCO's cost, there could be considerable indirect expenses incurred over and above the costs covered in the contract as a result of State employees devoting time and effort to the litigation, costs which are very difficult to quantify. Article 5.4 provides for an appointed State official "who shall act as Seller's coordinator for the purpose of facilitating the granting of permits by Seller and to act as a liaison officer for Buyer and Seller with the federal government." Since there is no provision in the contract as to who pays for this effort, it is assumed that the State will absorb this cost. These as well as other work which the State will be called upon to perform are costs for which no reimbursement provision exists unlike the situation which existed with the TAPS project and unlike the present agreement in principle for reimbursement of State incurred costs during the construction of the Alcan pipeline.

II. Liabilities

There are numerous instances which might be labelled liabilities to the State if the ALPETCO contract were approved. However, we believe that some of these liabilities are more perceptual than factual. Nevertheless, we are listing them here as they have emerged in public hearings for your review.

A. Performance Bench Marks

Some people feel that the so-called performance bench marks under Article 10 are inadequate to assure the State that ALPETCO will actually have to complete the envisioned petrochemical facility and bring it on stream, since the commitment of money to the project rather than an enforceable construction timetable seems to be the overriding factor in judging ALPETCO's performance. This concern is further accentuated by--

- (1) the delays and extensions which can be granted to ALPETCO, and
- (2) the fact that ALPETCO would be allowed to continue to take oil during this period, precluding the State to do anything else with its Prudhoe Bay royalty share.

Along similar lines, Mr. Lipton noted that if ALPETCO could not meet the bench mark dates set out in Article 10, it would be unlikely that the State would cancel the contract, because "as long as things continue to look prospective, one goes along."

B. Processing of Oil in Petrochemical Facility

The contract does not provide that the Prudhoe Bay royalty oil must be processed in the envisioned petrochemical facility

(4.2.1), nor is ALPETCO required to process 30,000 b/d at the proposed refinery for in-state use (4.3).

C. "Brokering" of Oil

Concern has been expressed that there is nothing in the contract which could prevent ALPETCO from continuing to "broker" a certain amount of Prudhoe Bay royalty crude or, for that matter, all of their entitlement after the petrochemical facility comes on stream (13.1).

D. Size of Petrochemical Facility

The contract only requires ALPETCO to expend an aggregate amount of \$1.5 billion. Yet, all presentations by ALPETCO claim that the contemplated facility will cost \$2.5 billion or more, and all the benefits which have been cited by ALPETCO are based on a \$2.5 billion facility. If the project came in at \$1.5 billion, the promised benefits to Alaska would be diminished.

E. Article 2.4

Aside from the 70 percent option of future royalty oil, which might become available for in-kind taking, to which ALPETCO is entitled under the contract, this article provides that all future contracts "shall contain a provision that Buyer shall possess a paramount right to call for and receive such royalty oil in the event deliveries to Seller from the Leases and available for sale and delivery to Buyer fall below 145,000 barrels per day...." This requirement might prevent the State from entering into any meaningful, realistic, or competitive long-term contracts with other parties, since the State cannot assure supply.

III. Other Points Which Have Been Raised

Messrs. Lipton and Tussing pointed out that--

- A. The major oil and chemical companies did not bid on Prudhoe Bay royalty oil which made the sale contingent on the construction of a petrochemical facility in Alaska. Conversely, it has been pointed out that ALPETCO has limited marketing and financing capabilities.
- B. The Japanese market, on which ALPETCO relies so heavily, can be supplied more advantageously from other places than Alaska, and representations by ALPETCO about Japanese interest appear inflated.
- C. The project could get financing, even be on stream, and not be profitable. The likelihood that the State would let the project flounder or go under is unthinkable. Mr. Lipton

stated that the State would feel responsible to help ALPETCO, since--

- (1) it would be the only major project in Alaska, and
- (2) if the State did not come to the aid of ALPETCO during a difficult time, it may be viewed by others as the State not seriously considering development.

We believe the above points fairly summarize potential liabilities to the State which have surfaced to date. Questions which Battelle Northwest and ISER have been asked to address have not been touched upon in this memorandum. We hope you find the information useful.

EK:jm

P.S. We are enclosing a copy of a memorandum from Randy Berry which addresses several legal questions previously raised regarding the ALPETCO contract.

(Enclosure)

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

April 5, 1978

SUBJECT: Questions regarding ALPETCO contract
TO: Elke Kallab
FROM: Randolph Berry *RJB*
Revisor of Statutes

The three questions which I will attempt to deal with in this memorandum are the adequacy of the security provisions, the article relating to successors and assignees, and the effect of the use of the term "commit to expend" in Article 10.3 relating to time periods for performance by the buyer.

(1) With regard to the security provisions of the contract, Article 12.1, as discussed by Mr. Rogers, is an attempt by the parties to solve the problem resulting from the prohibition by certain owners of the TAPS pipeline on carriage of oil on which a lien exists. The language is intended to result in the release of the purchase money security interest at the time the oil enters the pipeline and its reattachment when the oil emerges from the pipeline at Valdez. The provision imposes certain obligations on the buyer to prevent the attachment of other liens at this point, and to the extent that the buyer complies with these obligations, the provision seems reasonably workable. In the event that the buyer does not comply with his obligations, the state would be in a position to hold the buyer in default but could find itself without the priority lien which the provision envisions as protecting the state. However, Article 12.2, with its alternate security provisions, would appear to adequately protect the state if it was actually put into effect.

(2) As to the provision relating to assignment of and succession, written approval by the state is required prior to the voluntary assignment by ALPETCO of its interest in the contract to a trustee or lender as security for bonds or indebtedness. Further approval by the state is not required in the event of foreclosure or other assumption of ownership

Elke Kallab
Page 2
April 5, 1978

rights by the trustee or lender but the state would retain all its security interests until all sums owed to the state under the agreement were paid. Although it is possible for the agreement to be assigned by the trustee or lender to a third party without approval by the state, this could only be done if that third party assumed all the obligations and liabilities of the buyer under the agreement.

(3) The term "commit to expend" used in Article 10.2, was explained by Mr. Rogers as meaning entering into a binding contract for construction or purchase of materials or equipment relating to the petrochemical facility, but without any requirement in Article 10.2 as to time for performance of these contracts. While it is understandable that the buyer would prefer not to have time limits for completion of the facility specified in the agreement, since the agreement does not give the state any right to review or approve the terms of the construction contracts, the state is left somewhat at the mercy of ALPETCO as to the timetable for the actual construction of the petrochemical facility.

RB:jpd

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

March 27, 1978

SUBJECT: Entitlements - ALPETCO Contract

TO: The Honorable Bill Miles

FROM: Elke Kallab *EK*
Research Analyst

I have received your note regarding the entitlements program and how ALPETCO might or could use it.

I have spoken to the administrator of the Entitlements Program in ERA and he told me that presently ALPETCO's entitlements would amount to \$2.07/bbl, plus roughly 5¢ under the small refiner bias. These entitlements would most likely be applicable to the total 150,000 bbl/d petrochemical facility capacity, not just the 30,000 bbl/d energy fuels refinery capacity.

The entitlements (\$2.07/bbl) would be applicable during the interim taking of crude as well, since the entitlements accrue to the refiner.

Unlike what the attached letter from Bonner and Moore seems to indicate, the ERA felt that crude oil used to make products intended for export by the petrochemical facility would be subject to the entitlements.

The above information was offered in a telephone conversation, and specifics might have to be modified if the subject is thoroughly investigated. However, I believe the information might provide you with some idea about the size of the entitlement available to ALPETCO.

We have also asked Battelle to look at your question and to respond to it along with the other questions which they are addressing.

EK:jm
Attachment

cc: Marv Clement, Battelle

*answered
as Question # 10.*

AGO 545470 +

Copy given to Ward Swift 2/16/78

Bonner & Moore Associates, Inc.

500 Jefferson | Cullen Center

Houston Texas 77002

Area Code 713 659-1871

Cable: BONMOB

February 10, 1978

Dr. Robert E. LeResche, Commissioner
State of Alaska
Department of Natural Resources
11th Floor, State Office Building
Pouch M.
Juneau, Alaska 99811

RECEIVED
FEB 11 1978
Department of
Natural Resources

Dear Commissioner LeResche:

I am writing to comment on two recent developments that favorably affect the evaluation that we made of the Alaska Petrochemical Company (Alpetco) project. The first development is the conditional agreement of Mr. Gordon Caine to join Alpetco as Chief Executive Officer. The second pertains to a re-examination of Alpetco's economics. Mr. Caine, now Chairman of Petrotex Chemical Corporation, is personally and professionally known to me. He has industry experience and stature that will add greatly to the credibility and competence of any future Alpetco project implementation. While this development doesn't equate with the existence of a major petrochemical line and staff management organization it definitely would eliminate the strong negative rating that was given Alpetco in the management area. My management rankings would not change but Mr. Caine's presence and the continued use of Chem Systems as Consultants would more closely equate the management resources of Alpetco and Alaska Oil & Chemical Company.

It has also been brought to my attention that representatives of Alpetco have questioned our economic evaluation of their proposed royalty oil project. Specifically, an objection has been raised that no crude oil entitlement credit was included in our evaluation. After discussions with Mr. Willard Hanzlik of Alaska Interstate I now believe that the Alpetco project should properly be credited with some crude oil entitlement.

The crude oil entitlement program is designed to equalize the cost advantage among US refiners of purchasing price controlled domestic crude oil. Crude oil processed to produce material for export is specifically excluded from consideration in determining the degree of crude cost equalization due a refiner.

AGO 545471

Bonner & Moore Associates, Inc.

Dr. Robert E. LeResche, Commissioner
State of Alaska

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February 10, 1978

In the Alpetco economic calculations submitted as an Appendix to their proposal to the Royalty Board no credit was taken for a crude oil entitlement. Because of this curious omission the Alpetco spokesman was specifically questioned on the point during the November public hearings in Valdez. At that time it was stated that Alpetco had investigated the matter and concluded no entitlement credit would be available for their project. Since reference was also made to supplying export markets from the proposed Alpetco plant the omission of entitlement credits appeared to be correct.

After discussing this matter with Mr. Hanzlik, I am convinced that Mr. Barbour's Valdez statement was incorrect or does not properly reflect the current project realities. If our evaluation is not constrained by the record of Alpetco's proposal and prior public testimony then my judgment would be that a crude oil entitlement ranging from \$1.15 to \$2.30 should be credited to the Alpetco evaluation.

The lower figure would correspond to a case where half the plant output were petrochemicals and were exported. The remaining half would then be fuel products and be sold domestically. In the case where all products were sold domestically the higher entitlement would apply. These cases, in our judgment, bracket all real situations that might apply to Alpetco. Since the matter of Alpetco's exports seems so uncertain it is difficult to be more definitive.

The critical table that should reflect this change in our evaluation is Table 8, Page 3-13. A revised table is attached.

Section 4, Conclusions should be modified consequently. Our ranking, A. Economic Viability, would now list:

1. Alpetco
2. Alaska Petrofining
3. Alaska Petroleum Co.

Our commentary would state: The element of uncertainty in the Alpetco economic projections would suggest that both the Alpetco and Alaska Petrofining proposals should be viewed as substantially and comparably viable. The Alaska Petroleum proposal is somewhat less attractive, economically, but still fully qualified.

Bonner & Moore Associates, Inc.

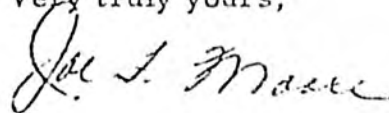
Dr. Robert E. LeResche, Commissioner
State of Alaska

-3-

February 10, 1978

Comments about Alpetco in the report Summary do not warrant changing. In that section we cited only the uncertain business prospects. It has been my judgment that Alpetco was content with the project's economics and their determination to go forward was not qualified in our evaluation. The business uncertainties surrounding both the Alpetco and Alaska Oil & Chemical projects remain substantial, compared to the refinery projects.

Very truly yours,



Joe F. Moore
President

JFM:mc
Attachment

cc: Mr. Don Wold
Mr. Charles Honig
Mr. Willard M. Hanzlik

TABLE 2
ALPETCO CRUDE PRICE COMPARISONS

	<u>BONNER & MOORE (\$/B)</u>
In-Value Price Range Excluding Field Costs	6.04 - 6.33
In-Value Price Range Including Field Costs	5.41 - 5.76
Deemed Economic Price Range	5.95 - 7.10
Deemed Economic Price Range Using Alpetco's Average Product Price of \$30.33/B	7.63 - 8.78

Expired February 9, 1975

F48-111

Bonner & Moore Associates, Inc.

3-13

AGO 545474

What Entitlements would accrue

to ALPETCO

Now!

Under Proposed Amendments!

- 150M b/d Petrochemical facility
- 30M b/d energy fuels refinery capacity for in-state use
- Interim taking of crude, roughly from 1979 through 1983 or longer.
- Products to be marketed on W.C. and ~~Pacific Rim~~ Japan.

Alaska oil in the rule
is treated as if it
were not for entitlement
purposes

get entitlement

Net effect $\rightarrow$ 2.07/b Jan. '78
 $\downarrow$

reduce the cost to a
refiner by that amt

ALPETCO - precedents that
Petrochem - treated as refinery

Entitlements accrue to refiner
not ALPETCO

$\downarrow$
investment benefit to ALPETCO

Mart. Clements 509 946-2270

~~Refining~~

Summe ~~refiner~~ ~~2~~ bias
100
150M b/d → 5¢/b (rough)
175M 0¢

~~Refining~~

DOE
 ① Steam Mills - Audit + Enforcement Program
 202 254 3070

- Trade Hearing
 Enforcement Hearings

Adm. Reg. adm.
 McTier - ERA
 Adm. - Anti-Human Program
 202 254 - 8660

Customary
 General Counsel
 Hargrett Division
 202 526 - 9575

Proposed Amendments to
 Enforcement Program
 See

State Representative

North Pole Railway
 → Northern Railway - Tom Williams

GVEA

ARCO

Rice - Center of Environment

ALPETCO

Sunday

Σ/ke:
What can we find
out about How Alpetes
can/ plans/ may use the
entitlements program?
B. White

Σ/ke

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

March 20, 1978

SUBJECT: ALPETCO Sales Contract (W.O. #5141)

TO: Representative Bill Miles

FROM: Randolph Berry, Revisor of Statutes

The purpose of this memorandum is to answer and discuss the questions developed by Elke Kallab regarding the proposed ALPETCO contract. These questions will be responded to in the order presented in the request.

1. (a) Article 2.3 prevents the state from entering into any long term sale of royalty oil at a "lower price" than that of the royalty oil sold to ALPETCO. The state can sell royalty oil for a lower price for a short term (up until the petrochemical facility is operational), but could not enter into a long term contract for sale at a lower price which would extend beyond the date the facility is operational. Use of the effective date of the contract appears to immediately guarantee ALPETCO the protection of this section, but in fact makes little or no difference, since the critical factor is not whether the state enters into a contract with a third party, but whether the state ceases sales at the lower price on the date that the petrochemical facility begins processing crude oil.

(b) Article 10.2(3)(d) does not prevent ALPETCO from receiving royalty oil prior to the end of the 18-month period; the 18-month time frame is the period within which ALPETCO must comply with the requirements of Art. 10.2(3). If ALPETCO has obtained the financing commitment contained in Art. 10.2(3)(d) in a lesser period of time, then it would be eligible to call for initiation of delivery under Art. 2.2 at that time. Although Art. 2.3 would already be in effect, it would only apply if the offer to a third party at a lower price extends beyond the initiation of processing by the petrochemical facility.

2. Although the contract document is dated February 22, 1978, the actual date of execution for the purposes of Art. 2.4 would be the date of final signing of the contract, rather than the February 22, 1978 date reflected on the first page of the contract document.

3. Article 4.2.2 provides that the commissioner, in deciding whether to approve or disapprove a proposed site, "shall consider the desires of the people who live in the immediate surroundings of any proposed site." This does not require the commissioner's decision to be controlled by the objection. However, the approval or disapproval of a site for the facility under Art. 4.2.2 only is relevant to compliance with the contract, and does not give ALPETCO any additional rights to build the facility in a particular location. ALPETCO would still be subject to any local or state zoning or other land use restrictions to the same extent as any other private company.

4. Art. 4.3 does not actually require ALPETCO to produce energy fuel for in-state use. ALPETCO is required to build into the petrochemical facility the capacity to process 30,000 barrels of crude oils per day into energy fuels. Although ALPETCO does not appear under the contract terms to be required to actually utilize the specified capacity to produce that quantity of energy fuel, in this and other instances in the contract it seems to be assumed that the required investment will operate as sufficient economic incentive to bring about the desired performance by ALPETCO. The provision contains the additional requirement that if ALPETCO does not use the royalty oil in its petrochemical facility, then it shall utilize its "best effort" to assure that 30,000 barrels per day be processed in-state into energy fuels. Presumably this would be applicable should ALPETCO begin to take delivery of royalty oil under the contract prior to the completion of the petrochemical facility. In this context, "best effort" would mean that ALPETCO would be required to take all reasonable steps to achieve in-state processing; although what is reasonable in a particular situation may be open to differences of opinion, it is a commonly used judicial concept.

5. Although study of the language of the provisions of Art. 10.2 relating to extensions of the time limits for contract performance by ALPETCO leads me to the conclusion that total extensions are limited to the single longest extension and do not cumulate, (and this interpretation is supported by comments by the Commissioner of the Department of Natural Resources), the manner in which the contract was drafted with repeated reference to a six month extension after each time limit could lead to confusion, and in my view, a written agreement by the department and ALPETCO as to the meaning of the extension provision would be helpful.

6. No. It would perhaps be helpful to one not familiar with the contract, but it is not necessary.

7. Although Articles 15.2(vii) and (viii) are comparatively broad in their scope, presumably the particular language of these provisions was the result of contract negotiations, and the advisability of the language used is a policy rather than a legal question.

8. Although the legislature cannot itself amend the contract, any of the contract provisions would be open to amendment if the department and ALPETCO agreed to the amendment prior to approval by the legislature.

Additional questions:

9. Article 12:

The question raised is whether the provision requiring voter approval of contract amendments resulting in a reduction of the price paid to the state could cause timing problems. The answer is yes; however, it appears that this provision would be more likely to work to the detriment of ALPETCO than the state, since it would delay the effect of a price reduction.

10. Article 2.3 and 2.4:

Does the legislature forego the opportunity to vote on any future sales contracts which may be executed by the administration by virtue of Articles 2.3 and 2.4?

Any offer of sale made under Art. 2.3 would be a new offer for sale of royalty oil for purposes of AS 38.05.183 and AS 38.06 and would be subject to royalty board and legislative approval. However, the operation of Art. 2.4 would not appear to be a new sale, and royalty board and legislative approval of the current ALPETCO contract would appear to be sufficient to allow Art. 2.4 to come into operation without further approval.

RB:hjd

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

March 20, 1978

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✓
? I believe
the contract
has been signed!
/ W.T. Ong

AGO 545483 +

3. Article 4.2.2 provides that the commissioner, in deciding whether to approve or disapprove a proposed site, "shall consider the desires of the people who live in the immediate surroundings of any proposed site." This does not require the commissioner's decision to be controlled by the objection. However, the approval or disapproval of a site for the facility under Art. 4.2.2 only is relevant to compliance with the contract, and does not give ALPETCO any additional rights to build the facility in a particular location. ALPETCO would still be subject to any local or state zoning or other land use restrictions to the same extent as any other private company.

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5. Although study of the language of the provisions of Art. 10.2 relating to extensions of the time limits for contract performance by ALPETCO leads me to the conclusion that total extensions are limited to ⁶⁻¹² six months, (and this interpretation is supported by comments by the Commissioner of the Department of Natural Resources), the manner in which the contract was drafted with repeated reference to a six month extension after each time limit could lead to confusion, and in my view, a written agreement by the department and ALPETCO as to the meaning of the extension provision would be helpful.

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not nec
since it ?
part
of the petro-
chemical
refinery!
(are you
sure?)

? 9+12 →

Representative Bill Miles
March 20, 1978
Page 3

8. Although the legislature cannot itself amend the contract, any of the contract provisions would be open to amendment if the department and ALPETCO agreed to the amendment prior to approval by the legislature.

RB:hjd

For Randy Berry - 3/20/78

Questions raised--

By Battelle: Article 10

"Expend or commit to expend or cause contractually bound parties to expend or commit to expend..." means very little in terms of actual performance or completion of such commitments. (Jerry McCutcheon hinted at this as well).

By Rep. Chat Chatterton: Article 14.3

What does "material or substantial" mean in this context. Suppose the State incurred no financial loss; would a court still find ALPETCO in default, breach or failure of performance? When is it material or substantial?

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

March 16, 1978

SUBJECT: ALPETCO Contract - W.O. #5141

TO: Randy Berry
Staff Attorney

FROM: Elke Kallab *EK*
Research Analyst

Rep. Joe McKinnon has asked that we look at the section of Article 2.3 which requires the State to "first offer to Buyer the opportunity to purchase ninety percent of the royalty oil proposed to be offered. Said oil shall be offered to Buyer at the same price, and on the same terms and conditions, as offered to third parties." Mr. McKinnon's concern is that under this provision the State could get locked into a long-term contract with ALPETCO way beyond the termination date of the ALPETCO contract now before the legislature. We discussed this same section of Article 2.3 with Fred Boness on Tuesday, although in a different context, and were told by him that "opportunity to purchase" means that a new contract would have to be submitted each time Article 2.3 is exercised, which would have to have Royalty Board and legislative approval before it could become effective.

What Mr. McKinnon would like to have is your written confirmation that any volumes acquired by Article 2.3 would require individual contracts, necessitating legislative approvals.

EK:jm

cc: Hon. Joe McKinnon
Hon. Bill Miles

AGO 545487 +

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM

March 14, 1978

SUBJECT: ALPETCO Contract - W.O. #5141

TO: Randy Berry
Staff Attorney

FROM: Elke Kallab *EK*
Research Analyst

An additional question has been raised with regard to articles 2.3 and 2.4, and we would appreciate your comments.

Does the legislature forego the opportunity to vote on any future sales contracts which may be executed by the Administration by virtue of articles 2.3 and 2.4?

Thank you!

EK:jm

AGO 545488 +

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

March 10, 1978

MEMORANDUM

SUBJECT: Legal and Research Division Activities Related to Royalty Oil Studies.

TO: The Honorable John Rader The Honorable Hugh Malone
The Honorable Mike Colletta The Honorable Bill Miles
The Honorable Kay Poland
The Honorable John Sackett

FROM: Gregg K. Erickson
Director of Research

The purpose of this memo is to bring you up to date on what the agency is doing with respect to the administration's proposed sale of North Slope royalty oil to ALPETCO. We would appreciate any comments you might have on our current efforts, or other questions you believe might be appropriate for us to look at.

1. We have had underway since December of last year a study by Battelle Northwest evaluating the U.S. and worldwide markets for Alaska royalty crude, particularly in relation to the possible sale that crude under a long term, no strings attached, contract. This study has already produced some very valuable and useful information, and will be presented in its entirety to the legislature on March 16.
2. The Institute of Social and Economic Research at the University of Alaska is doing, under contract to the agency, an economic impact analysis of the proposed ALPETCO facility. The initial output of the study will be available April 7, and additional work will continue on it until the funds allocated (\$18,000) are exhausted, or the legislature acts on the contract, whichever occurs first. This study will particularly look at the population effects of the construction and operation of the ALPETCO facility, changes in personal income, overall impact on state revenues from sources other than proceeds of royalty oil sale, and related matters. This is primarily in an econometric study and will be under the supervision of Scott Goldsmith.

AGO 545489 +

March 10, 1978

3. In addition to the contract noted above in (1), Battelle Northwest is also addressing some specific questions which have been raised by the ALPETCO contract. A list of these questions is attached. We would be particularly interested in any additions which you might suggest. So far we have allocated \$10,000 of agency funds for this project. We hope to have responses to most or all of these questions before April 15.
4. The agency's legal staff is investigating whether the procedures followed by the administration in negotiating the ALPETCO contract were in conformance with state law, and the question of whether the commitment of undeveloped and undiscovered royalty oil is consistent with the statute. We hope to have preliminary answers to these questions by March 15, and a final report by the end of the month. Attached is a list of other questions being addressed by the agency's legal staff.
5. In addition to administering the contract work under (1-3) above, the research staff is looking into the pricing provisions contained in the ALPETCO contract. Further, we have prepared, and are adding to as we go along, a list of questions that the legislature itself may wish to address.

Attachments: 1. ISER Contract
2. List of questions for Battelle
3. List of questions for agency legal staff
4. List of other questions

GKE:dh

CONTRACT BETWEEN
STATE OF ALASKA
LEGISLATIVE AFFAIRS AGENCY
AND
UNIVERSITY OF ALASKA
INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH

The parties of this agreement are the LEGISLATIVE AFFAIRS AGENCY, on behalf of the Alaska State Legislature, hereinafter referred to as the "Agency", and the UNIVERSITY OF ALASKA, INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH, hereinafter referred to as the "Contractor".

THE PURPOSE OF THIS AGREEMENT is to provide the Legislature and the State with expert economic information on the expected effects of a proposed petrochemical processing facility.

IT IS THEREFORE MUTUALLY AGREED THAT:

CLAUSE I. - STATEMENT OF WORK

- (A) (PHASE I) - The Contractor shall prepare estimates of the economic impact of the petrochemical manufacturing facility proposed to be built by Alaska Petrochemical Company, with particular attention to changes in employment levels, personal income, state and local taxes, and population. The Contractor shall assume that the proposed facility will be sited in the vicinity of the city of Kenai. The estimates shall be conducted using the Contractor's MAP model of the Alaska economy.
- (B) (PHASE II) - The Contractor shall conduct such further analysis of the benefits and costs of proposed sale of royalty hydrocarbons as the Agency may from time to time request. Requests shall be submitted in writing.

CLAUSE II. - CONTRACTOR'S STAFF

The Contractor's principal investigator for work under this agreement will be Dr. Scott Goldsmith. The Contractor may assign other members of its staff to this project as it considers appropriate.

CLAUSE III. - PERIOD OF PERFORMANCE

- (A) Work under Clause I(A)(Phase I) of this contract shall be performed between 15 January 1978 and 7 April 1978. The Contractor recognizes that time is of the essence in completion of this phase of the work, and that the work product may be of no value to the Agency if delivered after 7 April 1978.
- (B) Work under Clause II(B)(Phase II) shall be conducted prior to 30 June 1978. Individual tasks shall be completed by the dates specified in the written requests for such work.
- (C) This contract may be terminated after 7 April 1978 by written notice of either party to the other.

CLAUSE IV. - PROJECT DIRECTOR

The Project Director shall be Gregg Erickson, Director of Research, Legislative Affairs Agency.

CLAUSE V. - COMPENSATION AND METHOD OF PAYMENT

- (A) Contractor's compensation for the work specified in Clause I(A) shall be _____, payable on completion of Phase I.
- (b) Contractor shall be compensated for the work done under Clause I(B) at the Contractor's published daily rates, a copy of which is attached to and made a part of this contract.
- (C) Expenses incurred by the Contractor in the completion of the work set forth in Clause I(A) shall be borne by the Contractor. Expenses incurred by the Contractor in completion of the work set forth in Clause I(B) shall be reimbursable by the Agency. Costs of travel approved in advance in writing by the Project Director shall be reimbursable to the Contractor on the basis of state per diem rates and coach class air fare.
- (D) Total compensation under this contract, including expenses, may not exceed \$18,000.

CLAUSE VI. - IN-CASH CONTRIBUTION

The Agency understands that the Contractor intends to apply the payment made under this contract to the "in-cash" and "overhead" contribution required in support of the "Research Proposal to Environmental Management Program, the Ford Foundation". The Agency neither endorses nor objects to this procedure.

CLAUSE VII. - RECORDS, DOCUMENTS, AUDIT

- (A) The Contractor shall maintain accurate records as may be required by the Project Director. The records are subject to inspection by the Agency or the Project Director at all reasonable times.

- (B) All documents, reports and writings generated as a consequence of work done under this contract shall become the property of the State of Alaska, and on completion of the work or at the termination of this contract shall be delivered to the Agency.

CLAUSE VIII. - REPORTS

The Contractor shall keep the Project Director informed as to the progress of the work performed under this agreement and shall provide progress reports as specified by him.

CLAUSE IX. - ALL WRITINGS CONTAINED HEREIN

This agreement contains all the terms and conditions agreed upon by the parties. No other understandings, oral or otherwise, regarding the subject matter of this agreement shall be deemed to exist or to bind either of the parties of this agreement.

IN WITNESS WHEREOF, the parties have executed this agreement on the dates noted.

UNIVERSITY OF ALASKA, INSTITUTE OF
SOCIAL AND ECONOMIC RESEARCH

LEGISLATIVE AFFAIRS AGENCY

E. LEE GORSUCH

Date

GREGG K. ERICKSON

Date

Accepted: UNIVERSITY OF ALASKA

Approved as to form:

HOWARD A. CUTLER
Chancellor

Date

William H. Hansen

AGENCY LEGAL COUNSEL

Attachment

Nine Questions

<u>Priorities</u>	<u>Question #</u>	
①	2.	2 pp.
②	1.	
③	5.	
④	7.	
⑤	3.	
⑥	9.	
⑦	4.	
⑧ + ⑨	6. and 8. will not be addressed by Battelle	

LEGISLATIVE AFFAIRS AGENCY

March 8, 1978

Questions for Ward Swift, Battelle Northwest (as per letter of 3/8/78)

a. point out ②
and reasons
which might be
causes of delay!

1. What overall probability would you assign to the likelihood that the ALPETCO project will actually come to fruition in the manner contemplated in the contract?

a. How likely is it for ALPETCO to be able to adhere to the time tables set out in article 10.2? (We have asked our legal people to seek clarification concerning the extensions of the various phases, since it is not clear whether the possible extensions are cumulative over the six years [10.2(1) to 10.2(10)]. They could extend the time table by an additional 52 months plus, if all extensions were granted to the maximum.)

b. In your best judgement, what affect will the lack of an assured supply of 150,000 b/d have on the implementation and successful completion of the contract?

c. What possible detrimental implications exist for the state if the construction and completion of the project were substantially delayed, particularly after the initiation of interim crude shipments?

problem with
ALPETCO delivering
the oil

2. What hazard, if any, exists that the royalty oil which may be taken by ALPETCO prior to plant start-up may disrupt the west coast oil market? Gulf Coast not W.C. where oil will wind up.

not disrupt!
not available to
market it!

3. Please review the provisions governing the price to be paid by ALPETCO (Article VIII), and comment on the actual effect of the calculation method contained in Exhibit "B".

a. — Under what circumstances can you envision the state offering future royalty oil for less than what ALPETCO is required to pay for Prudhoe Bay royalty oil as covered in article 2.3, ~~and~~ ~~initially~~ ~~the~~ ~~state~~ ~~at~~ ~~a~~ ~~price~~ ~~lower~~ ~~than~~ ~~the~~ ~~price~~ ~~paid~~ ~~by~~ ~~ALPETCO~~ ~~under~~ ~~the~~ ~~contract~~ ~~and~~ ~~the~~ ~~state~~ ~~at~~ ~~a~~ ~~price~~ ~~lower~~ ~~than~~ ~~the~~ ~~price~~ ~~paid~~ ~~by~~ ~~ALPETCO~~ ~~under~~ ~~the~~ ~~contract~~ ~~and~~ ~~the~~ ~~state~~ ~~at~~ ~~a~~ ~~price~~ ~~lower~~ ~~than~~ ~~the~~ ~~price~~ ~~paid~~ ~~by~~ ~~ALPETCO~~ ~~under~~ ~~the~~ ~~contract~~ ~~and~~ ~~the~~ ~~state~~ ~~at~~ ~~a~~ ~~price~~ ~~lower~~ ~~than~~ ~~the~~ ~~price~~ ~~paid~~ ~~by~~ ~~ALPETCO~~ ~~under~~ ~~the~~ ~~contract~~ ~~and~~ ~~the~~ ~~state~~ ~~at~~ ~~a~~ ~~price~~ ~~lower~~ ~~than~~ ~~the~~ ~~price~~ ~~paid~~ ~~by~~ ~~ALPETCO~~ ~~under~~ ~~the~~ ~~contract~~ ~~and~~ ~~the~~ ~~state~~ ~~at~~ ~~a~~ ~~price~~ ~~lower~~ ~~than~~ ~~the~~ 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low ①

4. Will the power requirements of the facility (assuming it is located on the Kenai Peninsula) create any spillover costs or benefits to other power users in southcentral Alaska?

5.

~~Under article 2.4 of the contract, the state will be committing up to 70% of otherwise uncommitted non-Prudhoe Bay royalty oil to fill out any shortfall in the 150,000 barrels per day which ALPETCO needs. Since it is almost certain that royalty oil from Prudhoe Bay will fall far short of the 150,000 barrels per day, this provision seems to sharply reduce our options with respect to disposal of any royalty oil which might become available in the future.~~

③

Presumably, market conditions and other factors may change substantially between now and the time that this option is exercised. Taking into account the pricing provisions in article 8.1 (and Exhibit "B"), what is the likelihood that we would be able to get a better deal in the future if we weren't bound by this option?

out

6. ~~The administration maintains that there are no risks or subsidies involved in this contract. Do you agree?~~

7. Under article 4.3 ALPETCO is required to construct a facility that will be capable of producing 30,000 barrels per day of energy fuels for "intra-state domestic and industrial needs". In light of the probability that the full 150,000 barrels per day of royalty crude will not be available, what is the likelihood that ALPETCO would leave this capacity idle in order to maximize petrochemical product output? (Presumably ALPETCO could conceivably devote all production to petrochemicals even if they did get the full 150,000 barrels per day of royalty or other source oil.)

④

8. Some observers have claimed that Alaska's negotiating stance, both with respect to the now cancelled royalty gas contracts and with respect to this contract, has created an impression "outside" that Alaska is not really serious about developing industry in the state. Do you have any information that would tend to confirm or refute the notion that we are being perceived this way?

out

9. What are the implications of requiring all future contracts to contain a provision which gives ALPETCO the paramount right to receive up to 70 percent of available royalty oil which is or could be taken in kind as far as volume and financing is concerned?

⑦

~~* [scribble]~~

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

FOURTH LEGISLATIVE SESSION
JANUARY 1978
SPEAKER: JAMES W. ALLEN

March 8, 1978

Questions for Ward Swift, Battelle Northwest (as per letter of 3/8/78)

1. What overall probability would you assign to the likelihood that the ALPETCO project will actually come to fruition in the manner contemplated in the contract?

*a point out
pitfalls!
and reasons
which might be
causes of delay!*

- a. How likely is it for ALPETCO to be able to adhere to the time tables set out in article 10.2? (We have asked our legal people to seek clarification concerning the extensions of the various phases, since it is not clear whether the possible extensions are cumulative over the six years [10.2(1) to 10.2(10)]. They could extend the time table by an additional 52 months plus, if all extensions were granted to the maximum.)

- b. In your best judgement, what affect will the lack of an assured supply of 150,000 b/d have on the implementation and successful completion of the contract?

*problem with
ALPETCO delivering
the oil*

- c. What possible detrimental implications exist for the state if the construction and completion of the project were substantially delayed, particularly after the initiation of interim crude shipments?

*not disrupt!
not ~~available~~ to
market it!*

2. What hazard, if any, exists that the royalty oil which may be taken by ALPETCO prior to plant start-up may disrupt the west coast oil market? *gulf coast not W.C. where oil will wind up.*

*? Ask
P. answer*

3. Please review the provisions governing the price to be paid by ALPETCO (Article VIII), and comment on the actual effect of the calculation method contained in Exhibit "B".

Gr

- a. Under what circumstances can you envision the state offering future royalty oil for less than what ALPETCO is required to pay for Prudhoe Bay royalty oil as covered in article 2.3, and is it likely to happen? (This, of course assumes such royalty oil becomes available for sale.)

4. Will the power requirements of the facility (assuming it is located on the Kenai Peninsula) create any spillover costs or benefits to other power users in southcentral Alaska?

Gr

(More to come tomorrow.)

AGO 545497 +

STATE OF ALASKA THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

HOUSE OF REPRESENTATIVES
SENATE
LEGISLATIVE COUNCIL

More Questions for Ward Swift, Battelle Northwest
(as per letter of 3/8/78)

- 3(b). (Elaboration of question 3, sent yesterday). Article 2.3 of the contract gives ALPETCO an option to purchase up to 90% of any oil that is sold or offered by the state at a price lower (taking account of transportation costs) than the price paid by ALPETCO under this contract. Given your knowledge of Alaska's oil market's, what is your assessment of the probability that circumstances which would bring this section of the contract into effect will actually occur?
- ✓ (c). Article 2.3 allows ALPETCO to reduce their purchases from Prudhoe Bay by the amounts purchased (presumably at lower cost) under article 2.3. One implication of this provision may be that the state, at a future date, may be able to grant a subsidy to ALPETCO merely by offering oil from sources outside of Prudhoe Bay at prices below market value. What other implications, if any do you see in the operation of 2.3?
5. Under article 2.4 of the contract, the state will be committing up to 70% of otherwise uncommitted non-Prudhoe Bay royalty oil to fill out any shortfalls in the 150,000 barrels per day which ALPETCO needs. Since it is almost certain that royalty oil from Prudhoe Bay will fall far short of the 150,000 barrels per day, this provision seems to sharply reduce our options with respect to disposal of any royalty oil which might become available in the future. Presumably, market conditions and other factors may change substantially between now and the time that this option is exercised. Taking into account the pricing provisions in article 8.1 (and Exhibit "B"), what is the likelihood that we would be able to get a better deal in the future if we weren't bound by this option?
6. The administration maintains that there are no risks or subsidies involved in this contract. Do you agree?
7. Under article 4.3 ALPETCO is required to construct a facility that will be capable of producing 30,000 barrels per day of energy fuels for "intra-state domestic and industrial needs". In light of the probability that the full 150,000 barrels per day of royalty crude will not be available, what is the likelihood that ALPETCO would leave this capacity idle in order to maximize petrochemical product output? (Presumably ALPETCO could conceivably devote all production to petrochemicals even if they did get the full 150,000 barrels per day of royalty or other source oil.)

- 9-1 no
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End of Questions

Telecopied
(automatic)
9:00 am
3-14-78
mm

509-946-2718

Question for Ward Swift, Battelle

9. What are the implications of requiring all future contracts to contain a provision which gives ALPETCO the paramount right to receive up to 70 percent of available royalty oil which is or could be taken in kind as far as volume and financing is concerned?

Questions submitted to Legal ^{Division} ~~Services~~ regarding work order on ALPETCO sales contract.

1. 2.3 - This section essentially entitles ALPETCO to receive, as of the effective date of the contract, up to 90% of other royalty oil that may be offered for sale by the State, if it is sold at less than what ALPETCO is required to pay for Prudhoe Bay royalty crude.

The section further states that the State can sell other than Prudhoe Bay royalty oil at a lower price until the petrochemical facility initiates processing of crude oil.

The questions are:

- a. If the State can sell available royalty oil under Article 2.3 for less, up until the facility comes on stream, then why should it be tied to the effective date?
- b. Since ALPETCO cannot receive Prudhoe Bay royalty oil until 18 months after the effective date of the contract at the earliest (2.2), why should the option of being able to take up to 90% of other royalty oil which is priced lower than Prudhoe Bay royalty oil be available to ALPETCO on the effective date of the contract?

2. 2.4 - The contract states that "...to protect and insure Buyer's right to receive at least 150,000 barrels of crude oil per day hereunder, after the date of execution hereof...". You stated that "date of execution" meant the signing of the contract, which would be February 22, 1978.

How can the State obligate itself to the provision of 2.4 before the contract becomes effective? Should "date of execution" maybe have been "effective date", and if so, how important is it to change it?

3. 4.2.2 - What legal recourse, if any, would a community have which was adjacent to the proposed site, and which objected to the location of the site? Does the contract language need to be changed?

4. 4.3 - Please clarify if this provision requires ALPETCO to produce up to 30,000 b/d of energy fuel for in-state use, or if it provides only for ALPETCO to "...utilize its best efforts to assure that at least 30,000 barrels per day of...royalty oil will be processed in-state for production into energy fuels for intrastate distribution and sale..." if it is not utilized in the petrochemical facility.

What is meant by "best efforts", and should it be defined to show what is intended? (This term is defined in 8.2.)

5. 10.2 - Need clarification of headings 10.2(2) through 10.2(9) as they relate to the extensions granted under them individually. (Maybe a provision for maximum amount of time for all extensions and delays [site selection] would solve the problem, although the Legislature will not be able to make that change.)
6. 4.2.2 - Is it necessary to reflect the cancellation option available to ALPETCO after two site disapprovals in 4.2.2?
7. 15.2(vii) These two force majeure clauses seem to be too loose (viii) and all inclusive. Do they need to be modified to protect the State's best interests? How about any of the other force majeure clauses?
8. Under what terms, if any, can the contract as presented to the Legislature be modified?

Also, would you please review the comments of Messrs. Phillips, Nizer, et al, carefully (I previously gave you a copy) to see what additional bearing they have, if any, on the existing contract. I am not always sure if their suggestions were incorporated, and if they were not, if it flaws the contract as a result of disregarding them.

Would you please pay particular attention as to the adequacy of Articles XII (Security) and XXIII (Successors and Assigns), since I am probably not sufficiently versed in these areas to ask the right questions.

MEMORANDUM

March 10, 1978

SUBJECT: ALPETCO Contract - W.O. #5141

TO: Randy Berry

FROM: Elke Kallab

In addition to the questions posed in W.O. 5141, would you also look at the following question:

Article XXII - This article provides for voter approval should the price under Article VIII be reduced. The question has been raised what problems might exist with the provision as far as timing is concerned? (For example, if ALPETCO waits until December 1980 to ask for a reduction in price, it appears voters would not be asked to vote on the question until the next general election, or November 1982.)

Thank you!

EK:jm

AGO 545504 +

3/9/78

Other Issues Which Require Attention:

1. 1.13 - Why are "total project costs" allowable back to 1975? Since ALPETCO did not come into existence until 1977, and since the State did not offer its Prudhoe Bay royalty oil for in-kind sale until 1977, what kind of expenses prior to that time could have been incurred, by whom, and for what amounts?
- Answered
ACS
100-1,000,000*

2. 2.6 - The State has agreed to supply ALPETCO with the pipeline fill and storage tank bottom requirements so that ALPETCO can fulfill their tariff obligations to TAPS. (The Administration advises us that approximately 1,000,000 barrels are involved.)

The State has further agreed to provide these volumes free of charge until termination of the contract.

3. 5.3 - While ALPETCO agrees to pay the costs of any litigation to clarify the State's legal storage rights under the leases, who pays the incidental costs of such litigation and how will they be determined? (AG's staff time, etc.)

4. 5.4 - a. What are the problems associated with the State on the one hand utilizing its best efforts to facilitate and support the granting and approving of ALPETCO's permits, and on the other hand being the regulator and issuer of these permits, and is this desirable?

- b. Should the State fund the state coordinator or should the State be reimbursed by ALPETCO, since it is acting on ALPETCO's behalf?

5. 5.5(ii) - This article provides that the State furnish ALPETCO with production schedules of solution gas, gas cap gas and condensate which are available from Prudhoe Bay. Why? The administration states that they have advised ALPETCO that the State could not legally provide ALPETCO with confidential material. If ALPETCO is confined to public data, which would be available to everyone, why make it a contractual item? If the purpose of the section is for the Administration to gather the data for ALPETCO, should the State be reimbursed by ALPETCO for providing this service?
- Answered*

6. The contract commits ALPETCO to expend \$1.5 billion in total project costs, including expenditures by governmental entities for required facilities in connection with the construction and operation of the petrochemical facility.

ALPETCO is on record that the proposed facility will cost \$2.5 billion. Is there any possibility that under the contract terms ALPETCO could scale down the facility to \$1.5 billion?

7. Final process configuration and production rates of the products to be produced at the facility will be determined by marketing considerations based on sales contracts for the products. What implication does this have for the final projected facility as currently proposed by ALPETCO? (See 6 above.)
8. ✓ Article 10.2 deals with a time-frame ALPETCO has to follow and allows for extensions under the various benchmark dates. No provision is made in 10.2 for additional delays which may be caused by site disapprovals by the State, and resubmissions of proposed site locations by ALPETCO (4.2.2).
9. Is the security interest under Article 12 and 10.2 sufficient to protect the State's best interests, or should other requirements be added to assure successful completion and implementation of the project, such as performance bonds or liquidated damages?

3/9/78

Environmental Questions and Answers

1. 4.2.2 - *Are 90 days sufficient to rule on the site?*

JERRY REINWAND: Yes, in the context of the contract.

2. 10.2 - *What is the difference between an Environmental*
(3)(f) *Impact Assessment and an EIS?*

JERRY REINWAND: An Environmental Impact Assessment is a "mini" EIS and usually precedes an EIS if one is required.

Will an EIS be required?

JERRY REINWAND: Yes, probably from the Feds (Corps).

3. *Exhibit "D"*

Check with DEC if they concur with the coverage. Is it sufficient? Are the limits and deductible enough to be properly covered?

JERRY REINWAND: Totally satisfied with Exhibit "D".

Overall, Mr. Reinwand thought the contract was quite adequate as far as DEC was concerned.

M E M O R A N D U M

TO: Representative Bill Miles
FROM: Lisa Nelson, Administrative Assistant
DATE: June 1, 1978
RE: Statements on taking oil in-kind and in-value

LeResche, Senate Special Committee on Royalty Oil and Gas, May 15, 1978

LeResche said in essence, the House amendment will cause the contract to fall apart. He explained: "Given the Unit Agreement and given the other set of factors, i. e. the way the petrochemical industry works, they might run 165,000 barrels one day, 140,000 the next; they might shut down for 3 weeks.

Meanwhile, try to work that within the six-month notice period; there may be a 12 - 20 day transportation period from Prudhoe to ALPETCO, it is clear that there is no way to adjust what we take from the producers finally enough to ensure that every barrel does go through this refinery, unless they have ridiculously large storage facilities which would make the project financially silly.

So, mechanically it doesn't work.

May 16, 1978, Fred Boness with House Special Committee on Royalty Oil and Gas

In the North Pole contract, Section 2.2.2 addresses the ability of North Pole Refinery to increase and decrease the amounts of oil they wish to receive.

Discussion was as follows:

Chatterton: This apparently can be done from month-to-month.

Boness: That's right.

Chatterton: As I read over here on page 6, that's not going to give the Department any trouble in administering this, is it?

Boness: No, we have the right to give daily notices to the producers which are effective 6 months thereafter.

Miles: If they are taking 35,000 (b/d), let's say they are taking the max, of Prudhoe, and they get a better deal from ARCO, then they say stop, just deliver the minimum, what does the State do with the 30,000?

Boness: We go back to taking in-value.

Miles: And there is no problem at all just going back and taking in-value there? I mean there is no problem with the producers or anything else?

Boness: No, provided you give the proper notice. The producers could have problems, but we have a legal right... it shouldn't cause the State any problem. We expect to have somebody that is responsible for administering these contracts. I mean, it is no different than having to send out a bill.

Chatterton: If there is no difficulty in administering this, why, then, there is no difficulty in administering this in any contract for the sale of royalty oil? Right?

Boness: Right. Wait, I am not sure, I feel like I am missing something here.

Chatterton: I think you are.

Fred explains that a good contract administrator is needed to assure the contract is strongly and fairly administered.

Chatterton: What I think I read... If I am North Pole, and I am taking 30,000 barrels per day of oil, but I think seven months down the road, I am only going to want to take five or ten thousand (b/d), I will give you notice, and you will give the producers notice, and so, we can drop to that amount in seven months.

Now I heard people testify that you wouldn't be able to do that in regards to other royalty oil sales contracts.

Now, why can you do it with one and not do it with another?

Boness: I don't know. Who testified that we couldn't do that?

OUTLINE OF ALPETCO'S PRESENTATION

OWNERSHIP

BENEFITS TO THE STATE OF ALASKA

VIABILITY OF PROJECT

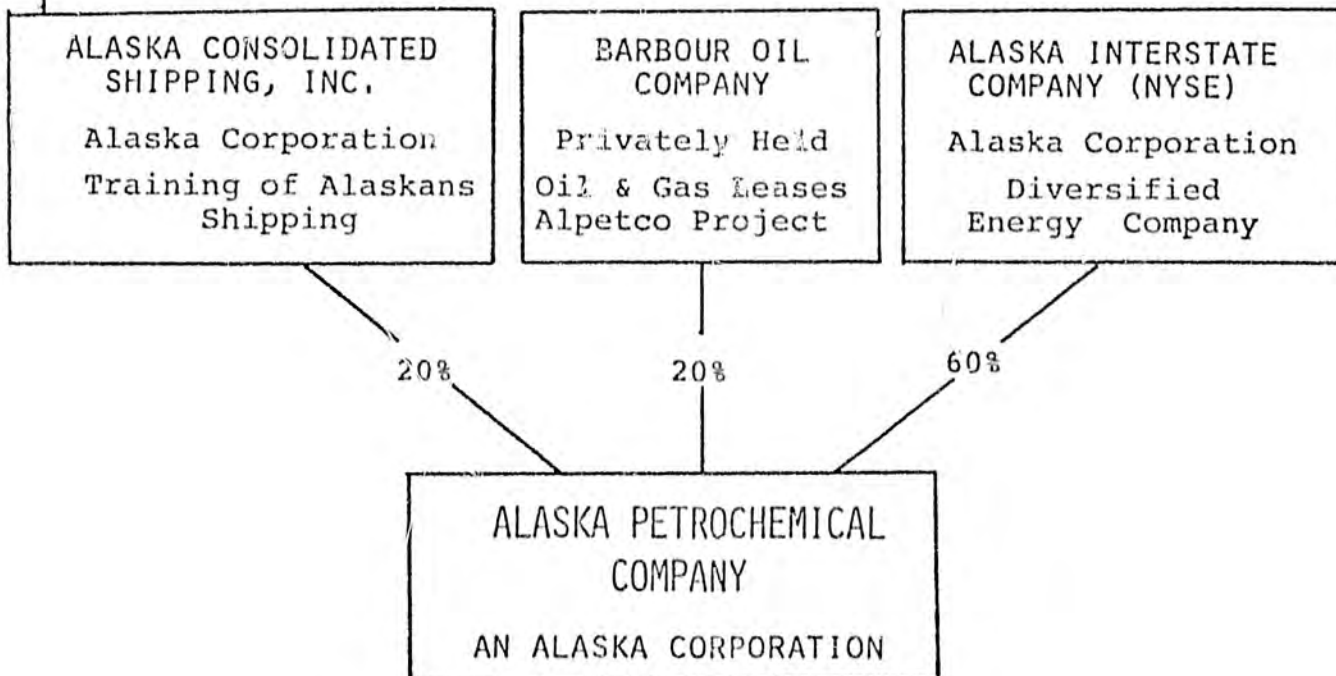
SUMMARY

MARCH 13-14, 1978

AGO 545386

OWNERSHIP OF ALPETCO

8.5%	The Aleut Corporation	
8.5%	Bristol Bay Native Corporation	
8.5%	Calista Corporation	Transmission-distribution of natural gas in Alaska since 1959
8.5%	Chugach Natives, Inc.	
8.5%	Cook Inlet Regional Corporation	Exploration, production and liquifaction of natural gas in Indonesia (for export to Japan)
8.5%	Koniag Regional Native Corporation	
51.0%		
49.0%	Seatrains Lines, Inc. (NYSE)	Exploration and production of oil and natural gas in the U.S.
	Shipbuilding	
	Container Transport	Engineering and construction of gas processing facilities
	Ship Charter	
	Port Management	Pollution control and sulfur recovery processes
	Oil Refining	Manufacturing



BENEFITS TO THE STATE OF ALASKA

NO RISK; NO SUBSIDY

ADDITIONAL EMPLOYMENT

ADDITIONAL TAXES

ALASKA ENDOWMENT TRUST

SHIPPING CAPABILITY

SPECIALIZED TRAINING

LOCAL HIRE

CONTROLLED INDUSTRIAL DEVELOPMENT

NO RISK TO THE STATE OF ALASKA

NO SUBSIDY

NO PRICE CONCESSION

PORT, DOCKS, UTILITIES ARE INCLUDED IN
ALPETCO'S CAPITAL REQUIREMENT ESTIMATES

NO INTERIM TAKE OF CRUDE

UNLESS & UNTIL OBTAIN COMMITMENT FOR PERMANENT
FINANCING

WE HAVE OBTAINED DEPT. OF ENERGY FAVORABLE
OPINION

PERFORMANCE BENCHMARKS

NO RISK TO ALASKA: PERFORMANCE BENCHMARKS

CONTRACT MAY BE CANCELLED BY STATE IF ALPETCO FAILS TO
ATTAIN EACH BENCHMARK AS FOLLOWS:

<u>TIME PERIOD</u>	<u>REQUIRED PERFORMANCE</u>
1ST 6 MONTHS	MONTHLY PROGRESS REPORTS TO THE STATE
THEREAFTER	QUARTERLY PROGRESS REPORTS
6 MONTHS	\$2 MILLION INVESTED SITE SELECTION BEGIN OPTIMIZATION DESIGN
12 MONTHS	\$3 MILLION INVESTED
18 MONTHS	\$10 MILLION COMMITTED CONTRACTS FOR SALE OF 70% OF OUTPUT GET FINANCING COMMITMENTS FOR \$1.5 BILLION COMPLETE ENVIRONMENTAL IMPACT ASSESSMENT FILE FOR PERMITS FINALIZE PLANT DESIGN
24 MONTHS	\$100 MILLION COMMITTED
30 MONTHS	COMMENCE CONSTRUCTION
36 MONTHS	\$600 MILLION COMMITTED
48 MONTHS	\$1 BILLION COMMITTED
60 MONTHS	\$1.2 BILLION COMMITTED
72 MONTHS	\$1.5 BILLION COMMITTED