

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672

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of the strongest people in the private sector will put their best efforts and their good money into making this work for the people of the state and that's what the contract is all about.

Now when you talk directly about the risks to the state -- there's been a lot of talk about a riskless contract. This is not a riskless contract. There is no riskless contract as far as I'm concerned. Nothing can be riskless and commit you for more than the next thirty seconds. There are risks inherent. I submit that these risks are very minimal compared to the extreme benefits that are possible under this contract. Let me just run down the supposed risks. There is an added administrative burden to the state if this contract is approved. No question about it -- it's a minor burden. The state would have to monitor the contract, we'd have to participate in site selection; we'd have to do some accounting as volumes of taking changed, whereas we don't have to do that now, taking in-value. We're required to litigate the storage question. We're required, as a state, to consider all the permits that these people are going to need as we would with any development project. We have some requirements to assist ALPETCO in looking at the measuring and testing, which is not a major thing; to assist ALPETCO in obtaining crude oil assays, which is not major; to help the buyer design the training and resident hire programs and to help them implement those, which are functions of the government as it exists now. Another supposed risk that we enter under this contract is the fact that we do in fact lose the option to do something else with this oil in the next 18 months. Now apparently Legislative Affairs asked Botel (ph) to consider this, you'll hear from them I think tomorrow. Basically there's nothing else to do with the oil in the next 18 months. The way I understand it, Botel will reconfirm that. In fact, this contract is a culmination of a very thorough and expensive search for alternatives as to what to do with this oil. None others have come up -- this is the best alternative. So the fact that we can't sell the oil to anyone else within 18 months, I do not think is significant. Two terms of this contract allegedly put the state under some vague future risk and I want to just briefly address these directly. These are 2.3 and 2.4, the infamous option terms.

2.3 is not an option term per se, but it is right of ALPETCO to have the opportunity to purchase any other state royalty oil which is cheaper at their refinery gate than Prudhoe oil -- if they then reduce their Prudhoe purchases by a like amount and only after their facility is on line. This is a

term they insisted on to protect them from another refinery or another petrochemical facility running them out of business using cheaper state royalty oil from right next door. It's a reasonable term. It does not burden the state. If they take this cheaper oil, they return the Prudhoe oil to us. There seems no benefit to the state to make it possible for someone else to drive this facility out of business which will, before this term can ever come into effect, be an existing in-state facility, which as you all know, rationally and politically we'll all be very pleased to protect. The other option term is 2.4. This is a term that gives ALPETCO the right to purchase up to 70% of any future royalties from other fields up to a ceiling of 150,000 barrels per day, aggregate ceiling, that is Prudhoe, plus these other sources. This also only comes on line once the facility is on stream. I think I might have misspoken on 2.3 but it's not significant now. We can go back to that. At any rate, this comes only once the facility is on stream. Now there's some vague fear about this and I'm not sure why, once we think it through. Before this term even applies, ALPETCO will be an existing in-state facility. Our statute requires that we not sell oil except as surplus to in-state needs. ALPETCO will be an in-state need at that time. Our policy says we'll favor existing in-state facilities without alternate sources. All we're doing is contracting what we would intend to do anyway and contracting what I submit we would do without fail anyway. Picture us ten years hence, a very large industry in the state running short of crude -- picture us selling alternate crude to someone else. We wouldn't do it. All this does is contract that we won't do it. In fact, it does better than that, it very clearly states that we would intend to withhold up to 30% for other potential uses. The 70% is not something ALPETCO wanted but we did preserve the option to the extent of 30%. But I submit you think this through. The option doesn't take effect until Alaska -- or until ALPETCO -- is an on stream facility in the state, an established in-state need. With that in effect, why would we sell to someone else anyway.

CHAIRMAN MILES:

Isn't that a Catch-22 though Commissioner?

COMMISSIONER LERESCHE:

No.

CHAIRMAN MILES:

You say we're committing it now and then down the line, there will be an in-state need to which we are committing ourselves, so it's okay to commit it.

COMMISSIONER LERESCHE:

I don't follow that, Bill?

CHAIRMAN MILES:

Well I don't either.

COMMISSIONER LERESCHE:

This term does not commit it unless there is an in-state need, by definition. If they don't come on line, the term doesn't apply.

CHAIRMAN MILES:

Go ahead, we'll get back to that.

COMMISSIONER LERESCHE:

Okay, I don't think it's a Catch-22 at all. What people seem to ignore is that this term doesn't even trigger until there's an in-state need. It's by definition, it's not a Catch-22.

Okay, all I'm saying is this term really contracts to do what we would do anyway and I think it's a good term. I'll tell you frankly, we're trying to get the term out of there for just the reason the people are objecting to it. It's difficult to understand. We're unable to excise that term. So, those as I see it, are the generally vague and/or insignificant risks that the state takes under this contract and I'd just ask you to compare these risks with what you've heard the last day and a half regarding the benefits, the job benefits, the increase in the in-state fuel capacity benefits, the tax benefits, the benefits of the trust fund, the benefits of having the state involved as a proprietor, not just a regulator in such things as local hire, job training and environmental affairs. So just to summarize what I've said, we're instructed by the legislature to explore all the alternatives to taking in-value. We did this, let us say, with a vengeance. We got private industry to spend hundreds of thousands of dollars exploring these alternatives within our stated criteria in terms. We put together the best deal possible through negotiation, given the present and predictable circumstances. This deal has a very high potential of benefits for the citizens of the state and it has minimal risks to the citizens of the state. The

contract relies entirely on private sector initiatives and mechanisms to put the facility together and to operate it. I think this is important. It does not make the mistakes that the come by chance refinery in eastern Canada made of getting the government involved financially in it. . But it creates incentives for private enterprise to put it together, that's how we wanted it. It seems to be only prudent for the legislature to confirm this sale as a solid epitome of the purposes of the entire concept of why the state retains a royalty interest as a lever for achieving more than can be achieved just with the money we would get by selling the oil at the wellhead.. Prudhoe is being produced. An opportunity like this is not going to knock again in the very near future. And I, of course, recommend very strongly that we take this opportunity now.

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SENATOR SUMNER:

Mr. Chairman. In 25.2, in regards to local training, who in the administration negotiated that section? When they talk about \$500,000 as having fulfilled their requirement (indisc. -- cough) in 10 years or that an aggregate of 1 million dollars had been expended from all sources, including federal, private and state funds on said program on or prior to 10 years from today, who negotiated that?

COMMISSIONER LERESCHE:

This was proposed by the Department of Labor and the Department of Law and Mr. Boness and I negotiated it. If you're implying that the numbers are low, I submit that they're not all that low. I submit that as part of the whole contract, but basically I submit that this firm includes six Alaska native corporations. And to me that's the best guarantee of all that this firm will be dedicated to local training and resident hire. I think that's a better guarantee than negotiating a very complex and (indisc.) term under the contract. But basically Senator, this was the best we could do in the total context of the contract.

SENATOR SUMNER:

I understand, but out of our committee already, we're asking for a million dollars in terms of expanding the Seward Skill Center to address some of these problems and when you talk about federal, private and state funds, essentially they're out from under the gun even before their own stream. These funds will -- this is by no means the magnitude at which the training -- if we are to

even in the period of ten years. We'll have no recourse as a result of the contract.

COMMISSIONER LERESCHE:

Well I think Fred wants to reply also, but I think you could understand why they were not anxious to negotiate an open ended commitment in the thing. That wouldn't have been prudent for them. Fred.

MR. BONESS:

I would just add in response to that that from a lawyer's point of view, if there's no threshold in there but simply commitment to local training and then there are allegations that that commitment isn't being lived up to, it becomes very difficult to determine whether a breach of the contract has occurred or not. And it was my recommendation that from the point of view of a lawyer or somebody looking at it in terms of the legal construct, some minimum would at least give you a threshold test and it was intended to be just that, a minimum -- not a maximum, a threshold test with respect to whether or not they were making an effort or not. If we left out the last part of the term which refers to dollar amounts, it would be much more difficult to determine whether or not a real commitment was made. Now I understand what you're saying about the amount of money. I would point out two things in that regard. First of all this money refers to training specific to the project. The million dollars for the Seward Skill Center, some of that may refer to training that would be adequate for this project and some of it may not so that this is not necessarily -- this million dollar commitment cannot fully be covered by actions of the legislature with respect to its overall commitment. ly

Beyond that I think your objective and ours is both simply one of insuring that training does take place. I don't think you particularly feel that it must be ALPETCO's responsibility to do the training, if indeed some other company or some other government body said we believe that's our responsibility and we see this project coming on line and are going to do it. So I think the contract was intended as Commissioner LeResche said, to reflect a commitment, but not necessarily to put the full responsibility and burden upon them.

SENATOR SUMNER:

Okay, but it wasn't intended to exclude them, either?

MR. BONESS:

No, definitely not.

SENATOR COLLETTA:

Okay, then the other part of my question is, how much consideration and what was the determination that was made on that consideration as to -- how does this commitment for the future weaken our future lease sales?

COMMISSIONER LERESCHE:

Lease sales? I don't see any connection.

SENATOR COLLETTA:

Because the availability of the buy back of the state's share in value certainly has to be a carrot for anybody bidding on something. (Indisc.)-- gas situation with Phillips. We were forced to go and drill another well because we decided to take that gas.

COMMISSIONER LERESCHE:

Okay, the answer is it weakens it to the extent that any royalty sale weakens it -- to the extent that the royalty statute weakens it. Certainly a lease purchaser would prefer to have 8/8's instead of 7/8's. This is a signal that we intend for them to only have 7/8's. I don't know how to calculate how much that weakens it, but that's been the state's policy since the royalty statute was established.

SENATOR COLLETTA:

And one other question probably to you is, in 2.4, was that applicable only to Prudhoe Bay -- the one phrase, and I don't remember the line and page but we had in all production that the state has an interest in, in fact then would Cook Inlet be eligible for delivery (indisc.)?

COMMISSIONER LERESCHE:

Under 2.4, yes.

SENATOR COLLETTA:

Okay, aren't we taxed to the maximum now in Cook Inlet with Tesoro?

COMMISSIONER LERESCHE:

There's an express exemption for Tesoro.

SENATOR COLLETTA:

(Indisc. - simultaneous speech).

COMMISSIONER LERESCHE:

But we are delivering all of our royalty oil to Tesoro. This contract would not interfere with that contract.

SENATOR COLLETTA:

No, but it would become eligible to delivery of oil. Would it not?

COMMISSIONER LERESCHE:

No.

SENATOR COLLETTA:

2.4 is inclusive of all state interests in production?

COMMISSIONER LERESCHE:

All state interests except Tesoro, North Pole and Golden Valley, which are explicitly mentioned in here. If there's new Cook Inlet reserves discovered, they would come under 2.4, the leases from which Tesoro is presently purchasing royalty would not come under it.

SENATOR COLLETTA:

Thank you.

CHAIRMAN MILES:

A couple of questions have recently been raised about the legal background of the contract. I don't mean questions arising from the non-winning bidders. Can you just give us an idea what legal basis you progressed -- legal background that went on for the contract?

COMMISSIONER LERESCHE:

I guess -- you mean for procedures that were used?

CHAIRMAN MILES:

Yes. And -- yeah. What did your lawyers say and do and who were they?

COMMISSIONER LERESCHE:

They were Fred, although I'm not sure that he can officially be an attorney any more, Cynthia Pickering (ph) and Jeff Hanes (ph), plus we retained Gene Kline (ph) from Phillips and Iser (ph) firm in New York to look at the commercial and

security sections of this. Fred could deal with -- I don't really know what the questions are. As far as I'm concerned we followed the statutes perfectly well. There was nothing even shadily illegal about this.

CHAIRMAN MILES:

I think you're reading something more into my question. Has the Attorney General signed off on the contract?

COMMISSIONER LERESCHE:

Yes.

CHAIRMAN MILES:

He's approved it and so we're all -- during the course of negotiations did you discuss royalty oil contracts with other states?

COMMISSIONER LERESCHE:

No.

CHAIRMAN MILES:

Why not?

COMMISSIONER LERESCHE:

Didn't feel any need to.

CHAIRMAN MILES:

Did you review royalty oil contracts from other states?

COMMISSIONER LERESCHE:

I assume that the attorneys did.

CHAIRMAN MILES

Which ones?

MR. BONESS:

California has a contract which they use from time to time and I'm told Louisiana attempted a deal somewhat similar to this,

although I have not seen the contract that they put together, if in fact they tried to put together a deal that never went through in Louisiana.

CHAIRMAN MILES:

The reason that I raised the question -- go ahead please.

COMMISSIONER LERESCHE:

I would point out that to my knowledge and I've certainly not made an attempt to canvass it, but no other state has a royalty statute at all similar to ours in terms of the obligations it places upon either the executive or the legislature with respect to the sale of royalty oil. The federal government, for example, sells oil through U.S.G.S. it's sort of -- under a standard form contract and there are regulations, federal regulations for the sale under that. I believe California operates under a procedure quite similar to that -- the sale is made by the lands commissioner. In no other situation are there quite all the steps or quite all the burdens or implications, they may not necessarily be burdens, set forth. So I'm not sure other states, or the federal government's contracts, or even private contracts are particularly helpful, I don't know. All the contracts that I know about are essentially posted price contracts, calls for oil. They're straight buy/sell oil contracts. Ours -- this contract is really two contracts. It's purchase and sale of oil and it's a commitment to construct a facility and do various other things for the state.

CHAIRMAN MILES:

Well the reason I'm asking, I've gone through some other contracts of royalty oil sales from other states and the language, the tone of the other contracts, is substantially different from the tone of this contract. For example, one contract says that if somebody would make the state a better offer, the person taking the oil at that time can meet that offer. If they don't meet the offer, they can sell to the other company -- to the higher offer. And that's -- that would substantially be in the state's interest to have language like that.

COMMISSIONER LERESCHE:

Sure, if the only thing involved was price for the oil, it would. Given that a lot more is involved, I can't see how we could practically put that in.

CHAIRMAN MILES:

Well I think it's something that should have been considered and there's other royalty oil contracts that call for premium payments. Bonus payments.

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COMMISSIONER LERESCHE:

Okay. We considered bonuses, we considered premiums, we considered price hikes, the whole thing. We considered all those without considering specific -- at least without myself personally considering specific other state royalty contracts. When you're buying and selling a commodity over a short term, you can build all that sort of stuff in. When you're putting together a very large, long term development project, those things are not feasible.

CHAIRMAN MILES:

Well why wouldn't it be feasible if the value of the oil is going up substantially, at least Milton Lipton's theory being that availability is more important than pricing, why wouldn't a premium inflator be feasible? I disagree with you there.

COMMISSIONER LERESCHE:

I can't imagine what you're thinking. This price is tied to the general price of oil. I mean it's our wellhead price as well back from what people are getting for it. It reflects the inflator price of oil, which also reflects the scarcity value of it.

CHAIRMAN MILES:

We've heard for two days now that one of the major aspects of the sale of this oil is that it's a domestic supply. Was it impossible or did you bring it up with the bidders, the possibility of paying for that, paying for that benefit, that it is an assured twenty-seven year supply? When the price of oil goes up, we get more than (indisc.)?

COMMISSIONER LERESCHE:

We certainly did and this contract reflects that they certainly have paid for it.

CHAIRMAN MILES:

I'm saying over and above the average price, the weighted average price?

COMMISSIONER LERESCHE:

This is above the weighted average price.

CHAIRMAN MILES:

How much?

COMMISSIONER LERESCHE:

It depends on conditions outside. It's tied to the weighted average but it's above it. It's essentially the west coast price as calculated in the leases.

CHAIRMAN MILES:

Well, okay.

COMMISSIONER LERESCHE:

-- which is far above the weighted average price. They also took the risk of paying any added charges that are added on by virtue of taking in-kind, which is something that costs them something, I'm sure.

CHAIRMAN MILES:

But we can't put a price on it?

COMMISSIONER LERESCHE:

No, because it's a probability judgment.

CHAIRMAN MILES:

What do you want to follow on that?

MR. CHATTERTON:

Well, no, I'll let anybody else who wants to follow, because I'm going to change the subject, but I will ask one question and I don't have it here but it's (indisc.) on your pricing schedule, is the price that we're going to receive for our royalty oil the weighted average? .

COMMISSIONER LERESCHE:

No. Kirt could explain it. He's got the explanation down to about 8 minutes. I'm sure you'll understand it. It's the weighted average of the price paid by each producer but it's not the weighted average of the price they get.

MR. CHATTERTON:

Right, okay, but it's not the west coast price either?

COMMISSIONER LERESCHE:

That's what it boils down to. No. Because Sohio, for example, doesn't pay what they're getting for their oil, they pay what the other producers are getting, which is the west coast price.

The other producers pay what they're getting. Each producer pays the highest of four things; their actual market price; the market value; the prevailing price, which is the price all the oil producers are getting; or the posted price, which of course doesn't exist. So it calculates roughly to west coast price because of ownership percentages and things like that.

MR. CHATTERTON:

I'll do my homework. Mr. Chairman, if I may, I have a question but it would change the subject.

CHAIRMAN MILES:

Go ahead.

MR. CHATTERTON:

Thank you, Mr. Chairman. Commissioner, Article XXII, where was the genesis of Article XXII? Or what was the genesis?

COMMISSIONER LERESCHE:

Okay. Yeah, the genesis came from two places. The first sentence was initially in there. There might be minor amendments, immaterial amendments, but any amendment, we just wanted to be very clear, had to pass the Board and the legislature. The second part came directly from the Governor. He said I want another roadblock ahead of increasing the price. Basically any contract can be amended by the Board -- well the Commissioner, the Board and the Legislature. The Governor asked that we put in another hurdle, that being the people. That's where the second sentence came from.

MR. CHATTERTON:

Mr. Chairman, if I may continue. Commissioner, don't you have concern about that section and concern along these lines -- I think we've all witnessed the media campaign, propoganda campaigns that are mounted that can sway the opinion of the people even to the point of where they might vote against their best interests? Do you have concern about that?

COMMISSIONER LERESCHE:

No, sir, I don't. Because it still has to go through the Executive Branch, the Royalty Board and then the Legislature before it even gets to the people. Now without this clause it would have to go through those three and then it would be fact. Certainly as you experienced recently, people can put

a media campaign on you that might or might not influence the Legislature to do something. This just puts another roadblock in front of it, four instead of only three.

MR. CHATTERTON:

If I may continue, Mr. Chairman. Do you suppose that this very phrase about the referendum is one of the prime reasons that the Governor can now support this sale?

COMMISSIONER LERESCHE:

I don't know how to answer that. He directed that that be put in there.

MR. CHATTERTON:

I'm wondering without it if he could still support this thing?

COMMISSIONER LERESCHE:

I didn't presume to answer that. It's a good contract without it. This just puts another shield, another floor under the price.

MR. CHATTERTON:

Thank you Mr. LeResche, thank you Mr. Chairman.

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

If I might call upon the same question. I guess it disturbs some people as to why there's any consideration given at all to the reduction in price. If there's no possibility of reduction in price, you wouldn't need anything by referendum.

COMMISSIONER LERESCHE:

That's correct.

MR. PARR:

So why have it in there at all? If we was just told Commissioner the price is going to be the same, it's going to be the west coast price etcetera, etcetera.

COMMISSIONER LERESCHE:

That's right. With no mention, the thing would be open to amendment by only three bodies, the Department of Natural Resources, the Royalty Board and the Legislature. There's no way to write a contract that's not amendable. If you say this contract is not amendable, then you just amend out that sentence. It's a labyrinth, but as far as I'm concerned this is the highest level of protection that it's possible to put into a contract. The Legislature can change laws, you know, I think this is the most layers between ALPETCO and the price reduction that we could conceive of.

MR. PARR:

You didn't find it -- I guess ALPETCO, didn't find it necessary to have any layers between that and a price raise? Why are we mentioning only a price reduction, in other words, and not mentioning an upward adjustment? That's the real question, That's what is disturbing the people. It isn't the fact that you put the referendum in there. It's the fact that you mentioned a reduction and you didn't mention the increases.

COMMISSIONER LERESCHE:

That's right. The increase can be handled by four parties, ALPETCO as one of the signers of the contract; the Executive Branch; the Board and the Legislature. Frankly it's good negotiation. We don't want the people to necessarily vote on the price raise. It's easier to get a price raise than a reduction, let's say.

MR. PARR:

The implication from that, of course, is there will only be negotiations regarding a price reduction. It's just that simple. It's not intended that way, but that's the implication.

COMMISSIONER LERESCHE:

No. Okay.

MR. PARR:

No question about it.

COMMISSIONER LERESCHE:

Okay, I guess I understand that.

CHAIRMAN MILES:

Commissioner, on what basis did you -- I presume -- did you make a finding that Tesoro would service the in-state needs?

COMMISSIONER LERESCHE:

On the basis of the study that I think ISER did for the Royalty Board and on the basis of the contract. The only period of time in which this oil could be conceivably be going out of the state is the time from 18 months until the facility is on line. Clearly we will have a large surplus of crude oil for in-state needs during that period. Once this facility is on line, it's an in-state need and there's no question, because it's not going out of the state.

CHAIRMAN MILES:

Every time you say that. Obviously, I have a different feeling about that.

COMMISSIONER LERESCHE:

Well put yourself in 1985. ALPETCO's on line, there's an in-state demand, what's the lack of logic there?

CHAIRMAN MILES:

Well we're making the commitment now, Commissioner, this is 1978. You're asking us to make the commitment now. You can't justify future in-state needs 7 years down the line, now. So I'm saying it's going to be an in-state need 7 years hence. Now that's putting the cart before the horse and tipping it upside down.

COMMISSIONER LERESCHE:

Well, I disagree. How can we ever enter a contract for more than a microsecond then? You have to make some assumptions. And this is more than an assumption. It's contracted. It's not sold unless it's an in-state need.

CHAIRMAN MILES:

Back on the legal problems. Did the Royalty Board give you written approval of the sale of non-Prudhoe oil?

COMMISSIONER LERESCHE:

Yeah, they approved the contract.

CHAIRMAN MILES:

Well don't you have to have a finding, specific finding made and --.

COMMISSIONER LERESCHE:

They made five or six specific findings.

CHAIRMAN MILES:

But didn't all those findings and all those resolutions relate to specifically as with the proposal that went out. The proposals that went out were just for the sale of Prudhoe oil, right?

COMMISSIONER LERESCHE:

They weren't exclusive but they didn't specifically include more, you're right.

CHAIRMAN MILES:

So that means they were just for the sale of Prudhoe oil?

COMMISSIONER LERESCHE:

No. That means they were explicitly -- they didn't explicitly exclude other oil; they didn't explicitly offer other oil.

CHAIRMAN MILES:

Yeah, they didn't offer any other oil. What they offered for sale was Prudhoe oil?

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

No other oil?

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

Okay, I can't find where you have the authority to go ahead and sell that without written approval of the Board.

COMMISSIONER LERESCHE:

We have written approval of the Board.

CHAIRMAN MILES:

Is that right?

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

Because the resolutions that waive the bidding procedure all seem to speak to Prudhoe oil only.

COMMISSIONER LERESCHE:

They speak to this contract.

CHAIRMAN MILES:

Which one?

COMMISSIONER LERESCHE:

This one.

CHAIRMAN MILES:

Which resolution?

COMMISSIONER LERESCHE:

All of them.

CHAIRMAN MILES

Well I have the resolutions here. It seems to speak to Prudhoe oil only. I've got eight of them. And I'm just wondering if we're going to run into a legal problem there if there wasn't any official finding and the law wasn't completely complied with?

COMMISSIONER LERESCHE:

Okay.

CHAIRMAN MILES:

We've got a legal opinion that says that.

MR. BONESS:

We haven't had the benefit of that opinion.

CHAIRMAN MILES:

I didn't until yesterday either. You'll certainly want to have a copy of it.

COMMISSIONER LERESCHE:

Yesterday. Well we could do several things. We feel -- Jeff, Jeff Hanes (ph) and Fred feel that we have no legal problem. I doubt it's significant enough a problem that it couldn't be corrected at the next Royalty Board meeting. It would be nice if we could have the opinion sometime though.

CHAIRMAN MILES:

Yeah. I just got it yesterday, myself.

CHAIRMAN MILES:

Joe.

MR. MC KINNON:

Did I understand you to say that the purpose of 2.3 is to prevent any sort of competitive pressure on ALPETCO from another in-state facility?

COMMISSIONER LERESCHE:

Using royalty oil, yes.

MR. MC KINNON:

Is that a wise policy to give ALPETCO a veto over other projects within the state?

COMMISSIONER LERESCHE:

Not a veto, a chance to meet the price.

MR. MC KINNON:

Well the practical effect which may be the vetoing of another feasible facility.

COMMISSIONER LERESCHE:

Not necessarily. It will release a barrel of Prudhoe oil for every barrel they get under that. And it's tied to the value at the refinery gate. But you're right. The fact of it is that they did not want another firm to be able to come in and drive them out of business using state royalty oil.

MR. MC KINNON:

How is the financing of the economics of this, let's say second refinery, could be entirely different. It's going to depend on the fact that they may be getting state oil cheaper than the oil ALPETCO will be getting. doesn't necessarily mean that the final product they're going to be producing will be any cheaper than that which ALPETCO is coming up with.

COMMISSIONER LERESCHE:

That's right.

MR. MC KINNON:

And yet we're giving them veto over this even though necessarily it doesn't mean that the low price will (indisc. -- cough) the second company to undercut.

COMMISSIONER LERESCHE:

That's correct. I still say it's not a veto, but it's a chance to meet the price.

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

Just a minor point, Mr. Commissioner. I think you said a while ago that you already have a contract with Golden Valley and you're about ready to close one in North Pole, right?

COMMISSIONER LERESCHE:

Yeah.

MR. PARR:

That contract with North Pole, is there -- looking down the road as far as we can reasonably see -- will the contract with ALPETCO cause any problems for North Pole, getting as much oil as it needs?

COMMISSIONER LERESCHE:

No sir, I don't think so. Fred could speak more to that, he's been negotiating with --.

MR. PARR:

In a sense, they were here first. They didn't waif any kind of guarantee from the state. They came in and built their refinery -- not as big a one, I realize, but nevertheless they stuck their necks out, came into the state and here they are.

COMMISSIONER LERESCHE:

That's correct and we in fact backed all of the other proposers back off the 90% to 85% in recognition of that fact.

MR. PARR:

In other words there's no problem with them getting what they'll need if this contract goes into effect?

COMMISSIONER LERESCHE:

As far as I'm aware, they're pretty much, if not totally, satisfied with their volume term and this -- 15% will certainly be significant to them.

MR. PARR:

Thank you.

CHAIRMAN MILES:

Commissioner, by essentially guaranteeing a specific quantity of oil -- this is a subject that -- I don't know if you were here yesterday, but the ALPETCO people and I disagreed on -- I certainly feel that there's a specific quantity guarantee, they seem not to think that but -- what effect will that have on our regulatory powers insofar as we do to some extent control the rate of flow? Doesn't that -- won't we be sacrificing or isn't the position very, very possible we'll be sacrificing what's in the best interests overall of the State of Alaska for some economic concessions just to get up to 145,000, 150,000 barrels a day?

COMMISSIONER LERESCHE:

Any commissioner or any oil and gas conservation committee or any oil and gas conservation commission who could allow those things to influence their conservation decisions ought to be summarily dismissed. There would be no excuse for such a thing.

CHAIRMAN MILES:

Well that's in fact -- we know that doesn't happen, nobody gets summarily dismissed.

COMMISSIONER LERESCHE:

Nor, I don't think we've ever made a decision for our proprietary interest which reneged on our conservation regulatory responsibility.

CHAIRMAN MILES:

Yes, but it's a strong possibility, isn't it?

COMMISSIONER LERESCHE:

No, what if we don't have a contract. We've still got to monitor the interest in royalty.

CHAIRMAN MILES:

Well, we're talking about -- we're assuming that we do have a contract. That's why we're all here.

COMMISSIONER LERESCHE:

I'm saying the problem exists with or without this contract. If there's a problem.

CHAIRMAN MILES:

But doesn't it exist to a much more severe degree?

COMMISSIONER LERESCHE:

I don't think significantly more severe. Certainly if there's an industry in the state that uses 150,000 barrels of crude a day, there's pressure built to produce crude for that industry. But that's just inherent in our dual role of regulator and owner.

CHAIRMAN MILES:

Well it relates to, again, the initial point of should we be selling a quantity or a percentage.

COMMISSIONER LERESCHE:

Yeah, Bill, we're selling a percentage with a specific ceiling on the percentage, that being 150,000 barrels.

AGO 545571

CHAIRMAN MILES:

But let's face it, we're essentially guaranteeing up to 150,000 barrels, regardless of -- you can call it what you want, but

that's essentially what we're guaranteeing is 150,000 barrels.

COMMISSIONER LERESCHE:

No, we're saying -- we're guaranteeing 85% of Prudhoe, 70% of any others, but never to exceed 150,000 barrels. We're guaranteeing percents.

CHAIRMAN MILES:

So ALPETCO gets 150,000 barrels?

COMMISSIONER LERESCHE:

If we have it.

CHAIRMAN MILES:

Yeah.

COMMISSIONER LERESCHE:

We're creating a demand for it, no question about it. But if all we have is Prudhoe and if 85% of it is 100,000 barrels, we haven't guaranteed them 150,000 because we don't have it.

CHAIRMAN MILES:

Yeah, I understand that. But if we have it, we're guaranteeing 150,000?

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

Right. Okay.

COMMISSIONER LERESCHE:

Well if we have it within the 85% --.

CHAIRMAN MILES:

Within the 15 and the yeah, I understand. Well that's just a philosophical difference, I guess.

COMMISSIONER LERESCHE:

Metaphysical.

CHAIRMAN MILES:

No, I can't spell that. It just seems like we're really putting

the fox right in the chicken coop.

SENATOR SUMNER:

Mr. Chairman, yesterday you asked that same question and I was under the impression, the way you were wording it, and again today -- if under all the worst possible circumstances coming about, would we still be required to deliver that 145 or 150,000 barrels a day. It's my understanding that that would not happen if all the positive things flow and the yield is such that the percentages as outlined in here would come up to 145 or 150,000 barrels a day. To that extent, they would be guaranteed that take. But at the same time that guarantee limits them to 150,000 too. But under the worst of all possible circumstances and the flow rate was not such, that this percentage yield 150,000 barrels, the state would not be guaranteeing that. We wouldn't have to go and buy from somebody and --.

CHAIRMAN MILES:

No, no. But my point is that the flow rate, you just mentioned, can be changed to deliver that -- to require the state to deliver 150 thou.

SENATOR SUMNER:

But this wouldn't do it here?

CHAIRMAN MILES:

Oh, it would do it as much as anything else.

COMMISSIONER LERESCHE:

Mr. Chairman, I'm sure you understand the procedures whereby these flow rates are established and being sure that you understand that, I can't really understand your question. They are totally unrelated to this whole deal with the exception that it's regulated by unit operators and state employees.

CHAIRMAN MILES:

By state employees, yes, well that's a strong relation.

COMMISSIONER LERESCHE:

But it's about as far away as you can get, given that their both state employees. We were talking about that earlier.

CHAIRMAN MILES:

(Indisc.)

MR. CHATTERTON:

Mr. Chairman, I'm going to diverge again and come back to -- and I hate to have you take the 8 minutes, Fred, shorten it here -- but on this pricing, let me set up a scenario here, a very simplistic situation. Let's say 25% of the gross production from the field (indisc.) carries a wellhead value of \$6.00 a barrel, 50% of that production carries a value -- wellhead price of \$5.00 a barrel and 25% carries a wellhead price of \$4.00 a barrel. Now the weighted average to that of the whole 100% barrel is going to be \$5.00 a barrel, right?

UNIDENTIFIED SPEAKER:

Right.

MR. CHATTERTON:

We're to gather. Now that would make our 1/8 worth \$5.00 a barrel and the operating company's 7/8's worth \$5.00 a barrel, we're all together here, this is wellhead price.

MR. BONESS:

May I interrupt just for a second?

MR. CHATTERTON:

Yes.

MR. BONESS:

I don't believe you can do this kind of calculations without also assigning different incomes to different companies because that comes into it, but I'll follow through with your example before I explain why I think that's so.

MR. CHATTERTON:

Okay, you're going to confuse the heck out of me, Fred.

COMMISSIONER LERESCHE:

It's how you get the wellhead value, not how you average it out once you have the wellhead value. That's the big question.

MR. BONESS:

Why don't we go through the rest of your example and then I'll come back and explain to you.

MR. CHATTERTON

Let me go through the rest of my example to clarify one point in my mind then you can confuse the heck out of me.

MR. BONESS:

Okay.

MR. CHATTERTON:

Okay. Alright. So here we have our 1/8 and their 7/8's is worth \$5.00 a barrel at the wellhead. Now, so far as I know, why -- yesterday we had -- quite a point was made of the purchase point was the L.A.C.T. meter. I submit that 7/8's of this barrel is produced, or 7/8's of the production of any one day here, is now worth \$5.00 a barrel at the L.A.C.T. meter. We are in court as to whether our 1/8 is worth \$5.00 per barrel. Now what if we lose that court case? In other words what is ALPETCO going to pay us at the L.A.C.T. meter?

MR. BONESS:

Okay. For the purposes of your question -- I don't have any problem assuming that the L.A.C.T. meter 1/8 is worth \$5.00. Now, if we lose the court case and the court says you value royalty oil at the flow station, let's say, then the state will have to pay the producers a certain amount of money to get it from the flow station to the L.A.C.T. meter. We will still deliver to ALPETCO at the L.A.C.T. meter, they will still pay us \$5.00 at the L.A.C.T. meter, but now we're going to have to take some of the pennies from that \$5.00 and pay to get it from the flow station to the L.A.C.T. meter.

COMMISSIONER LERESCHE:

Which we'd have to do if we took in-value.

MR. BONESS:

If we took in-value, the producers would have paid us only \$4.90, if it's a dime from the flow station to the L.A.C.T. meter, \$4.90, so the state is in no different posture. The one potential difference -- one potential outcome which is covered by this contract is where if we take in-value, let's say we get the flow station -- let's say we get the L.A.C.T. meter price, the \$5.00. But if we take in-kind, we also get the L.A.C.T. meter price, but we have to pay cleaning and dehydrating cost because as you know, there's a difference in the lease. One paragraph makes specific reference to cleaning and dehydrating costs and one doesn't. In that situation, in order to make the state whole and still have \$5.00 in our pocket, we said that ALPETCO must reimburse the state for any costs incurred by reason of taking in-kind and make specific reference to cleaning and dehydrating cost, also with respect to other costs. So that ALPETCO would have to pay us the L.A.C.T. meter price, plus whatever we had to pay the producers, 30 cents cleaning and dehydrating

costs, so ALPETCO's L.A.C.T. meter cost would go up to \$5.30, even though the other 7/8's would continue to remain \$5.00. And had we taken royalty in-value, we would have gotten \$5.00. Under this contract, ALPETCO will then be paying us the L.A.C.T. meter \$5.30.

MR. CHATTERTON:

They would be willing to pay us more than what they could buy it from one of the owner companies?

MR. BONESS:

That's right. That term is in there because there's no other way to make the state whole. They are willing to take the risk that there's not going to be a difference in in-value and in-kind.

MR. CHATTERTON:

Well you've just made me question their acumen as being a businessman right there.

MR. BONESS:

Well it's a legal question, more than a business question.

MR. CHATTERTON:

Well let me interrupt, if I may --

MR. BONESS:

Okay.

MR. CHATTERTON:

-- which I did. This hypothesis we had was if we lose the court case.

MR. BONESS:

I have problems, we could win some of it and lose some of it. That's when the problem comes up. Not like there's one question and the answer's yes or no. The question is how must they pay us when we are taking royalty in-value? How must they pay us when we're taking in-kind? What must we pay if we take in-kind? And the answer is, it may not be an absolutely identical situation. In one case they may pay us \$5.00, to use your example. Let's say that the court says the proper place for paying royalty in-value is at the L.A.C.T. meter. The L.A.C.T. meter value is \$5.00. The court could also say when the state takes

its royalty in-kind, the state must pay cleaning and dehydrating costs. That means we've won the lawsuit with respect to our contentions on royalty in-value but lost them with respect to our contentions for taking in-kind. We say we don't have to pay cleaning and dehydrating costs in either event, notwithstanding the provisions in the lease.

MR. CHATTERTON:

We have some unknowns then?

MR. BONESS:

That's right. There are some unknowns.

MR. CHATTERTON:

Then obviously my question is, how can we make a determination today as to what is in the best interests of the people of Alaska until we first know the outcome of the court costs-- case?

COMMISSIONER LERESCHE:

We create an identity between what we would get at any time in the future if we'd never heard of ALPETCO and continued to take in-value and what we're going to get from them. That's why the price term is so complicated because it tracks future unknown events.

MR. BONESS:

There are no numbers in the price term -- in this contract. It adopts the concept that they'll pay us a sum of money equal to what we would have gotten had we continued to take royalty in-value. So we're not getting a premium as Chairman Miles has asked about. But we're not going to get less money than if we just continued to take in-value. And it is as complicated as it is because there are so many unknowns at this date.

MR. CHATTERTON:

Okay, thank you, I think. Thank you Mr. Chairman.

UNIDENTIFIED SPEAKER:

He confused me.

COMMISSIONER LERESCHE:

He left out 2/3's of it.

CHAIRMAN MILES:

Yes, I know, but that's easy to do. We're going to take a short 5 minute break to give these guys the chance to get a drink of water.

(Off Record)

(On Record)

CHAIRMAN MILES:

Questions.

Commissioner, the total project costs in the contract go back to January 1, '75. Would you give us the reason for that?

COMMISSIONER LERESCHE:

Not really. That's what ALPETCO wanted. The question arises -- it arose in my mind, what does this mean about the first benchmark, the promise to spend 2 million bucks before 6 months after the effective date. The fact is they've probably spent 1/2 million to a million already. That's fine. That's the conditions of the thing. The important benchmark, the first two, the two and three million dollar expenditure, was just a way to make them prove commitment continually and keep going. The key benchmark is 18 months. It involves 10 million bucks and financing for a billion five. So whether they spend a million two between now or between the time it's approved by the Legislature in six months or two full million, I think is insignificant.

CHAIRMAN MILES:

What would be included? What would be included back in October of 1975, perhaps somebody from ALPETCO could answer, if you don't know?

MR. HONIG:

My understanding is that the provision of the contract counts everything that we have spent since we began the effort of making a proposal to the state.

CHAIRMAN MILES:

Well it goes back to January 1 of 1975 and ALPETCO wasn't even formed, to my understanding, until last year.

MR. HONIG:

One of our major stockholders was Alaska Consolidated Shipping and they had incurred and did spend money in their same efforts, the same contract and my understanding is what they spent would be included in this amount. It's all for the same purpose.

CHAIRMAN MILES:

Might we get a copy of those expenditures?

MR. HONIG:

Yes, I'm sure.

COMMISSIONER LERESCHE:

They just want to write off Henry. (Laughter)

MR. HONIG:

We've already done that.

CHAIRMAN MILES:

Talking about the benchmarks, we have a number of extensions that are available and they total over four years if my addition is right. Doesn't that have the effect of substantially delaying the project after four years.

COMMISSIONER LERESCHE:

They're not cumulative, Bill. They're each measured from the effective date.

CHAIRMAN MILES: Well, if each extension was granted, each benchmark, it could be cumulative?

COMMISSIONER LERESCHE:

No. Okay, you've got, let's say, the 18 month benchmark can be delayed six months and that's measured from the effective date. So say they have two years, if it's necessary to meet the 18 month benchmark. The 24 month benchmark can also be delayed six months. But 24 months is measured from the effective date, again.

CHAIRMAN MILES:

From the effective date, that (indisc.--sumultaneous speech)

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

-- I just misread that. Any questions? I have plenty but --. Senate?

SENATOR SUMNER:

I think I can sort of summarize, the fact that I don't have any questions doesn't mean that at some future date I won't, it just merely means that at this time I haven't had an opportunity to review the contract in some detail and to attempt to track down some of the questions that I will have by both staff and consultants' support and at that time come back with some questions, but that's my posture at this time.

CHAIRMAN MILES:

Okay, well we might as well call it a day.

MR. BONESS:

Okay, thank you very much Mr. Chairman.

COMMISSIONER LERESCHE:

Thank you, Mr. Chairman.

***** End of Proceeding *****

Lipton

3/15/78

Observations:

① advantages to Alaska

Basis for ind. establishment/development.

③ Prospects of Success

Disposition of chem prod on W.C.
is a reasonable assumption - a
potential market

Foreign Mkt - the most elusive and
difficult to predict - the areas
from which it can be
supplied "look well so
much more attractive
than Alaska"

Incentives for investments in
the middle East -

- Transp. disadvantage
 - Capital "
 - Assured supply
- } not because
of

political thrust to develop an
ind. profile for reasons difficult
to plathom - Inpt psychological
urge to assume a pivotal
political role - not just look

the role but act it
Export mkt ^{will} get carved out of
exportable supply; i.e., Middle
East

② Distaste to Alaska

If project can come to fruition,
but ③ becomes a reality then
what?

Interim Period

Due dates - if they cannot
be met even if ALPETCO performs
sincerely, will the State really
cut them off or will they afford
them the appt to make up!?
No. Then, what are the
risks for the interims being
tied to a contract.

Profitability

Does the group have the financial
wherewithal to stick ^{it} out for instance
5 yrs? Or will the State be forced
to lower the price

→ Prospect is leading the state to
→ got further and further sucked
in, assuming an equity position
Alaska does not lose too much by

deferring the decision.

Income tax based on in-state



Multi national

formula. It would not generate much in income taxes

Comment →

"First" sale should be in Alaska
this way would have a leg
up for tax purposes!!

Questions:

Cratterton: Risk - getting Cass - Yes!
(the legislature)
Should we take a risk
with the people's money
or not - Yes!

Parr: Main benefit - Breakthrough?
Yes!
What are the obsolete plants
in Japan with a modern
plants - ^{old plants} - ~~can~~ advantage
rather than liability
in many cases.

→ To the OK disadvantage outweighed
by assured supply? Question-
able!

We would be fighting the export
market, which is now being
increasingly determined (price)
by Middle East

Miles:

Future Reserves?

Another risk! May be
far more attractive in
the ^{mid/late} 80s - Assured supply vs.
"Alaska disadvantage"!

Pricing: We are being asked
to make the same commitment
as far as timing is concerned
as is ALPETCO

If the state thinks PB is it,
maybe the time is ripe
to make that commitment now
before too much is gone. If
the State feels more secure
in future reserves maybe
we can wait in committing
ourselves.

Hackley:

Would the sky fall in if we waited ^{and for how long?}

The sky will not fall by
delaying the contract. Urgency
is ^{about} availability now which
will decline.

A ^{or two} yrs will not be tragic;
but we are turning our
back on something that
came to ~~us~~ us in good
faith!

Catterton:

If Option 1 existed where would you
locate project? at
Volder or W.C. of the US?
W.C. absolutely!

Later commitment better than
earlier commitment!

Miles:

Sanders willing to offer
more than A/R!

They will offer over
and above. (150M + (50M)
150M to process - 50M free
of all strings).

AGO 545585

Stability of supply, looses
its attractiveness. Contradicts
Tydings!

Parr:

What are the risks?

Risks: Contract will collapse, most likely went.

Venture after venture fails
What is our credibility

→ - During time frames in
contract - not too bad

- After initiation first
5 yrs will be difficult,
and state will be
feel obligated to do
something not required
by contract.

State will not allow
it to flounder because
of a lack of cash
flow.

Royalty Canada Contract should
not be conditioned on
what state wants to
do with its gas

Widow's story

4. William Kipton and Dick Kofgren

Mr Kipton made his
comments in the form
of observations.

1. advantages to Alaska
... Successful implementation
of contract services as a
basis for industrial development
2. Prospects of Success

— The ~~prospects of~~ disposition
of chemical products on the
West Coast is a reasonable
assumption — the petroleum
market exists

— However, the foreign market
is not a ~~big~~ difference to
product. ~~Almost~~ Areas from
which petrochemicals
can be supplied
"look are as much
more attractive than
Alaska."

The incentives for investment
in the Middle East, which
~~are~~ are no better — maybe

(stable supply)
worse than Alaska is that
in addition to what ^{Alaska} ~~the~~ ~~state~~ is
offering, ~~they~~ the Saudis
are offering certain volumes
of crude over and above
those committed to the development
of a petrochemical industry
in their country with no
strings attached. Lipton is
thus in disagreement with
Joe Tydings.



Alaska State Legislature

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TRANSCRIPT OF TESTIMONY OF

MILTON LIPTON

March 15, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:

Chairman Mike Colletta
Pat Rodey
Bill Sumner
John Sackett
Kay Poland

Representatives:

Chairman Bill Miles
Chat Chatterton
Joe McKinnon
Charlie Parr
Al Osterback

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

back.

MR. LIPTON:

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

You just come on up.

MR. LIPTON:

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

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

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

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

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

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

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

petro-chemical capacity in the Middle East itself.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

MR. CHATTERTON:

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

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

MR. LIPTON:

There is a risk. There surely is a risk.

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Okay, fine. Fine. Thank you.

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

Okay.

MR. LIPTON:

That's it.

MR. PARR:

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

MR. LIPTON:

For a specific market. For a specific market.

MR. PARR:

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

MR. LIPTON:

Increasingly, yes.

MR. PARR:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

Absolutely.

CHAIRMAN MILES:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

MR. LIPTON:

For what? I'm sorry.

MR. OSTERBACK:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

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

MR. LIPTON:

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

MR. OSTERBACK:

Thank you, Mr. Chairman.

SENATOR HACKNEY:

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

MR. LIPTON:

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

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

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

CHAIRMAN MILES:

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

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

MR. LIPTON:

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

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

MR. CHATTERTON:

Thank you, Mr. Chairman.

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

Of course, of course. Surely, surely.

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MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

MR. MCKINNON:

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

MR. LIPTON:

Yes.

MR. MCKINNON:

Another (indisc.)

MR. LIPTON:

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

MR. MCKINNON:

Is that only for a deficiency out of Prudhoe?

MR. LIPTON:

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

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

MR. MCKINNON:

Yes, that's the way I interpret it.

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

I don't believe it does.

AGO 545607

MR. MCKINNON:

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

MR. LIPTON:

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

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

MR. MCKINNON:

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

MR. LIPTON:

Yes.

CHAIRMAN MILES:

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

MR. LIPTON:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

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

AGO 545609

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

MR. PARR:

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

MR. LIPTON:

They tended to be, yes. Very definitely.

MR. PARR:

Everybody has seen the possibility all at once?

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

Well, maybe commercial decisions and government-political decisions?

MR. PARR:

Possibly.

Thank you, Mr. Chairman.

MR. LIPTON:

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

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

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

CHAIRMAN MILES:

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

profile point that you made.

MR. LIPTON:

On the petrochemical investment there?

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

I'm sorry, I misunderstood you.

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

CHAIRMAN MILES:

Thank you.

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

SENATOR HACKNEY:

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

MR. LIPTON:

Remember what I said?

SENATOR HACKNEY:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

Yes. Sure.

MR. CHATTERTON:

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

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

CHAIRMAN MILES:

Thank you very much.

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

Present:

3/16/76

Osterbock

Greening

Miles

Parr

Chatterton

Battelle Northwest Presentation

Tussing

1. What is the likelihood that the ALPETCO project will be commercially viable?
 - (a) Comment on the "Alaska disadvantage" and on how ALPETCO might overcome it?
 - (b) Comment on the realism of ALPETCO's marketing plans for Japan and for the U. S. West Coast.
2. Is it possible or likely ALPETCO could get its project financed without an overwhelming assurance of its commercial feasibility?
3. What would happen if the ALPETCO facility were financed and built, and after its completion it were to be unprofitable? What would be the consequences for ALPETCO's sponsors, for the bondholders, for the employees, for the community in which the plant was located, and for the state?
4. If ALPETCO were to encounter difficulties either in financing the project or in operating it profitably, what other assistance, if any, would ALPETCO be likely to ask from the state, apart from a discount on crude oil prices? What would be the costs, risks or other implications for the state from these measures?
5. What will be the likely impact of the ALPETCO project on the West Coast oil market and on the value of Alaska crude oil generally, both before and after the proposed facility goes on stream?
6. Comment on sections 2.3 and 2.4 of the contract, specifically the option to buy non-Prudhoe royalty oil.
7. Comment on the procedures by which the Commissioner of Natural Resources and the Royalty Board decided to negotiate this contract.
8. How can the Legislature best resolve the factual, legal, analytical and policy questions presented by this contract?

B+M
see report

Tussing

ALPETCO CRUDE OIL RESALE SCENARIO, 1980

September 1977 Data
(Bonner and Moore)

Destination:	<u>Alaska</u>	<u>Cherry Point</u>	<u>California</u>	<u>Gulf Coast</u>	<u>Total</u>
Volume(mb/d)	82.5	452.1		178.8	713.3
					<u>Weighted Average</u>
Value at destination	12.50	13.30	13.38	13.77	13.35
less transportation from Valdez	(-)	(.60)	(.82)	(3.05)	(1.21)
Value at Valdez	12.50	12.70	12.56	10.72	12.13
					<u>Total</u>

Arco volume (mb/d)		143.0			143.0
Exxon volume (mb/d)	2.9	139.0			141.9
Sohio volume (mb/d)	74.4	141.6		167.5	383.5
Total Volume (mb/d)	82.5	423.6		178.8	713.3

1980 distribution (Bonner and Moore)	73.0	300.0	302.0	525.0	1200.0
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Assume Alaska and West Coast Sales Distributed among Companies in Same Proportion as 1977:

Arco volume (mb/d)		190.4		49.6	240.0	<u>Average Valdez Price</u> 12.23
Exxon volume (mb/d)	2.6	185.1		52.3	240.0	12.21
Sohio volume (mb/d)	65.8	188.5		390.1	644.4	11.46
Total volume (mb/d)	73.0	602.0		525.0	1200.0	<u>11.79</u>

The 1980 price to Alpetco would be \$11.79 (less pipeline tariff).

(6) Assume a price elasticity of demand for Prudhoe-grade crude oils on the West Coast of - 1; West Coast sales would increase by 30 mb/d. Assume ALPETCO's West Coast share is carved proportionally out of the other producers' shares. Therefore, the new prices and volumes would be:

Destination:	Alaska	West Coast	Gulf Coast	Total	Average Price
Value at destination	\$11.90	\$12.74	\$13.77		
less transport from Valdez (-)	(-)	(.71)	(3.05)		
Value at Valdez	11.90	12.03	10.72		
Arco mb/d		153.1	56.9	210.0	11.67
Exxon mb/d	2.6	148.8	61.2	210.0	11.79
SOHIO mb/d	65.8	151.5	346.6	563.9	11.20
ALPETCO mb/d		150.0		150.0	12.03
TOTAL mb/d	73.0	632.0	495.0	1200.0	11.48

The new priced ALPETCO would be \$11.48.

$$e = \frac{dQ}{dr} \cdot \frac{r}{Q}$$

$$e = -1$$

(1) If the process stopped here, Alaska would be losing at least \$69,285 per day, \$25.3 million per year as a result of ALPETCO's resale effort (31 cents per barrel on 150 mb/d royalty, plus tax of 7 percent of 31 cents on 1050 mb/d).

(2) ALPETCO, under the new circumstances, would be entitled to its royalty oil at a new, lower price of \$11.48.

(3) If, as is likely and contrary to the above assumption (4), reduction of the Valdez price to \$12.03 were not sufficient to penetrate the West Coast market with 150 mb/d, ALPETCO would still lose money on any crude oil it sold at the Gulf (cost \$11.48 + \$3.05 transportation = \$14.53; value is \$13.77).

(4) But ALPETCO could still undercut the prevailing West Coast price of \$12.03 plus transportation from Valdez, and increase its market share, if it was still willing to sell at cost plus 2 percent = \$11.71.

(5) Where would the process end? We don't know, but equilibrium would be reached only when the Valdez price for oil shipped to all destinations fell to the same value: \$10.72. In this extreme case, ALPETCO's resales would cost the state \$239,145 per day, or \$87.3 million per year (\$1.07 per barrel on 150 mb/d plus 7 percent of \$1.07 on 1050 mb/d).

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Alaska State Legislature

POUCH Y, STATE CAPITOL
JUNEAU, ALASKA 99811
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TRANSCRIPT OF TESTIMONY OF

DR. ARLON TUSSING

March 16, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:

Chairman Mike Colletta
Pat Rodey
Bill Sumner
John Sackett
Kav Poland

Representatives:

Chairman Bill Miles
Chat Chatterton
Joe McKinnon
Charlie Parr
Al Osterback

DR. TUSSING:

You all know who I am, and I won't waste time on introducing myself. I have a number of questions I intend to address myself to this evening, and let me run through the questions which I would deal with, if I have the time, which I won't, and we'll try to be selective. What I'll do is I'll take up one issue at a time, and let you discuss....let's have some interchange during the discussion. I won't have a formal presentation. We'll just take these issues up. Feel free to interrupt me if there is something you are not following.

Here are the issues that had been identified as possible areas for my treatment on which I'm ready to comment. First, what is the likelihood that the ALPETCO project will be commercially viable? And under that, comment on the Alaska disadvantage and how ALPETCO might overcome it. Second, comment on the realism of ALPETCO's marketing plans for Japan and for the U. S. West Coast. Third, is it possible, or likely, ALPETCO could get its project financed without an overwhelming assurance of its commercial feasibility? Fourth, what would happen if the ALPETCO facility were financed and built and, after its completion, it were to be unprofitable? What would be the consequences for ALPETCO's sponsors, for the bond holders,

for the employees, for the community in which the plant was located, and for the State? Fifth, if ALPETCO were to encounter difficulties, either in financing the project or in operating it profitably, what other assistance, if any, would ALPETCO be likely to ask from the State, apart from a discount on crude oil prices? What would be the cost risks or other implications for the State from any of these measures? Sixth, what will be the likely impact of the ALPETCO project on the West Coast oil market and on the value of Alaska crude oil generally, both before and after the proposed facility goes on-stream. Seventh, comment on Sections 2.3 and 2.4 of the contract, specifically the option to buy non-Prudhoe royalty oil. Seven, comment on the procedures by which the Commissioner of Natural Resources and the Royalty Board decided to negotiate this contract. And eight, how can the Legislature best resolve the factual, legal, analytical, and policy questions presented by this contract.

Of all of these things, I think that the Battelle presentation has set the background for discussing some of the issues which relate to the West Coast surplus. Firstly, let me say that the West Coast surplus will have, and is having, a consequence that the Battelle study did not point up and that is in exerting downward pressures on West Coast oil prices. And, as the West Coast surplus increases, those downward pressures will increase. I will want to show you in a brief scheme how these downward pressures are likely to work.

Taking a series of hypothetical prices at Valdez - these are net back prices at Valdez for shipments to various parts to various markets based upon what net back prices were posted by the company in September of 1977, with some modifications, but, essentially, the sales in Alaska to Alaska refiners were at \$12.50 a barrel; that is, as of Valdez. West Coast sales were at an average of \$12.63. Gulf Coast sales were at \$10.72. And this reflects the differences in transportation costs to those markets, as the average transportation cost from Valdez to the Gulf Coast was \$3.05, while the average transportation cost to California was \$.82, and to Cherry Point \$.60. And this is what results in the difference in Valdez price.

Okay, now let's move forward to 1980 and assume that nothing changes in terms of the real prices of oil, that the OPEC price in real dollars, remains constant, and the transportation costs remain constant. And that, of course, assumes that for the Gulf Coast price to remain constant and assumes there will be no higher prices.

CHAIRMAN MILES:

Doctor, are you sure that your figures are right there - \$12.50

at Valdez price for sale in Alaska and a higher sale for the West Coast?

DR. TUSSING:

Yes. I'm not sure these are right. I took this figure from Bonner and Moore, who claim to have derived it from state revenue figures. Since I had just one day to prepare this, I had to grab the only materials I had at hand. I didn't have a chance to go to the original data. Whether or not this is precisely right is irrelevant to the thrust of my explanation. What I am dealing with is the large difference between the West Coast and the Gulf Coast net back, and Battelle set out the same thing. They had different numbers, but they were in the same order of magnitude - roughly, a \$2.00 difference in the net back price from the West Coast and the Gulf Coast.

As you know, ARCO was able to market most of the oil through its own West Coast refineries; EXXON, a somewhat smaller proportion; and SOHIO, with no outlets of their own on the West Coast, must ship most of their crude to the Gulf Coast markets. Now projecting ahead the shares of the various markets to 1980, and assuming 1.2 million barrels per day, which is more than is going to be produced at this stage - but, again, it's a minor....I'm not trying to predict the future in this - but, projecting the differences, we have for ARCO an average net back price at Valdez of \$12.23, for SOHIO, an average net back price of \$12.21 - not for SOHIO....for EXXON, SOHIO - \$11.46, and for a total, including the other minor companies, a weighted average price of \$11.79.

Alright, now, what we see here is that the cost of oil for SOHIO is more than a dollar under the West Coast price. It's an interesting situation, which in our competitive textbook economics would say would not last very long because SOHIO, rather than accept this price for its oil, would want to penetrate this market for every barrel, additional barrel, that SOHIO could put into the West Coast market. SOHIO would make \$1.17 more. Our textbook market economics would say SOHIO would keep trying to sell oil on the West Coast until - what would happen if SOHIO tried to sell more oil out on the West Coast? They would drive this price down. In other words, to make room in the market, they would have to offer a discount because ARCO and EXXON are selling all they can at this price, or moving all they can at this price - the biggest customer is SOCAL - to displace more Saudi crude out of SOCAL's supply, or, for that matter, to convince refiners to not to take oil somebody else. So, SOHIO would have to offer a discount. Now, SOHIO would be ahead as long as it could get more than \$11.46; that is, on the last barrel. The reason SOHIO doesn't do this is that by pushing more crude into the West Coast they are not just making....suppose they offer it on the West Coast for

\$11.63, for a dollar discount. Well, they are making the difference between \$11.46 and \$11.63 on that incremental barrel but, in the meanwhile, they are provoking the others to cut their prices, too, to maintain their market share. The California independents will cut their prices to maintain their market share. So, all the producers would end up worse off than they were before, as they would all end up selling roughly the same amount of oil into the West Coast market. But all of them would be getting less, and the state would be getting less. So, SOHIO, because it's such a big element in the market, suffers most from its own competitive actions. SOHIO is not about to start a price war which will drive the West Coast price down.

Other than that, with the growing surplus, SOHIO really does want to market this. One of the things that came out in the suit of the Maritime Unions against the Virgin Island Exchanges - what was doing was SOHIO was swapping its oil with SOCAL; it was delivering its oil to SOCAL and taking SOCAL's Saudi crude and selling the Saudi crude in the Virgin Islands at a discount. They weren't discounting on the West Coast. They were posting their net back prices in Alaska as if they were selling it in competition with Saudi crude on the West Coast. Yet, they were taking a loss on the Saudi crude they sold in the Virgin Islands. So, in effect, they were discounting without it appearing on the books, and the State of Alaska was getting royalties and severance taxes on the basis of a crude price which was higher than the true value - the market value - of the crude. In other words, SOHIO was willing to pay a higher royalty and a higher tax than it had to, based on the true value of the crude in order not to appear to be pushing down the West Coast price.

This was what was happening with production at less than 700 million barrels a day - 700 thousand barrels a day. As production gets up to 1.1, the downward pressure of the temptation of any of the producers to try to get more of the West Coast market. All of them can do better on the West Coast than they can.... Their average price is lower than the West Coast price. They can all do better so long as that's the case.

Now, if competition broke out, what would happen is the West Coast price would be driven down to \$10.72. The competition that each of these producers, say SOHIO, would keep trying to sell more oil on the West Coast. It could keep making more oil on the incremental barrel, on the last barrel, by selling it on the West Coast at a discount until they got it down to this price.- until they were making no more from selling on the West Coast than they made on the East Coast. If they could receive \$10.73 by selling an extra barrel on the West Coast, instead of \$10.72 by selling on the Gulf Coast, they would do it, if there were competition. Now, where does ALPETCO come

into this?

In a situation where the surplus is going to be increasing, at least until 1985, and I suspect it's going to continue to increase faster than that - the projections that were cited by Battelle that show it falling off are both pessimistic about future discoveries. By 1985 we are going to have the (indisc.) Sea sale, the lower Cook Inlet sale - will have been taken place long enough that if there are any discoveries to be made there they will be ready to go on-stream. There will be, according to the Interior Department's schedule, seven more OCS leases off Alaska in that time, so that the supply may continue to expand far beyond the highest of those projections. While it's my belief we are in for a long period of low economic growth and low increase in energy demand, for reasons which you can see.

Now the economic management of the United States and the Free World is not really at its optimum, and I think that we're going to see very low rates of growth - of economic growth and energy growth, generally. So, we're going to have an increasing surplus on the West Coast, increasing downward pressure on prices if exports aren't authorized and if none of these proposed transcontinental pipelines are authorized. And I think the odds are against all of them. Anyway, you have continued downward pressure.

What does ALPETCO do? If it comes in as a petrochemical plant, it removes some of the surplus crude that otherwise tends to depress the West Coast price. It does not go into the petroleum market as such. And so a crude-base petrochemical facility in Alaska, or anywhere on the West Coast, if it used Alaska-type crudes, would reduce the surplus of crude on the West Coast, it would reduce the amount which has to be pushed through to the Gulf Coast. The weighted average price, the price that ALPETCO would have to pay under these assumptions, would be \$11.79. They would be paying \$11.79 essentially for oil that would otherwise have to be marketed on the Gulf Coast for \$10.72. So there would be two effects of that. One is that the pressure on the part of the other producers to market their surplus on the West Coast, and drive down the price, will be reduced. The second is that the weighted average itself will tend to go up because some of this will be pulled out. Some of the \$10.72 will be pulled out of the weighted average and replaced.... say, this is oil that SOHIO pays \$10.72 for, will be reduced.... and, instead, ALPETCO will be paying the \$11.79. So the weighted average will go up, and ALPETCO's price will be more than \$11.79.

So everybody's price will be....the total price will be higher. So, (indisc.) in that context, any facility which removes oil from the West Coast market and reduces the pressures on the West Coast market, the surplus is favorable to the state. Now, as the Battelle people pointed out, the thing that is over-

whelmingly most favorable to the state would be exports to Japan. I think that they made a good case that this is the best thing, under any circumstances, that could happen to the state. I think that the state has not devoted it the attention it might have to overcome the political bottlenecks. This is something that is a subject for another discussion, but I believe that exports could be authorized with the proper political strategy.

But, getting back to this.... Second best would be a petrochemical plant as opposed, say, to a products refinery which would simply push more oil into a West Coast market that's got more oil in. Now, (indisc.) from the petrochemical plant, however, to the ALPETCO proposal as a whole, there is another problem and one sees another picture. The proposed contract entitles ALPETCO to take up to 150,000 barrels, or up to its full Prudhoe Bay entitlement, of crude oil for re-sale up until the time their plant is ready to use it. Let's see what the effect of their taking that oil in (indisc.) will be. According to their pro forma financial statements, they intend to market their oil on the West Coast of the United States, and they intend to mark it up by two percent. Then they expect to earn a two percent margin on it and they give a purchase price of \$7.00 at the well head, plus shipping costs to the West Coast of \$.85, plus an ALPETCO margin of \$.25, and tax (indisc.) for \$5.40, and give a \$13.50 sales price on the West Coast. Well now they're starting with different numbers and I won't quarrel with those, because they are based on other assumptions as to what the actual tax tariff will be and what the net back will be. But the problem here is ALPETCO takes oil that costs the \$11.79 at Valdez, that is, well head price plus tax tariff, and there is no way that it can sell it on the Gulf Coast. ALPETCO gets 150,000 barrels, 140,000 barrels, of oil for \$11.79. They lose money unless they can sell it for \$10.72 plus transportation to the Gulf Coast, which is \$3.00. So there is no way that ALPETCO can consider marketing on the Gulf Coast. ALPETCO, if it takes this oil, has to go into the West Coast. What can ALPETCO afford to do? ALPETCO says that it is looking for a two percent margin, so that brings its price at Valdez to \$12.03. And, in that case, they can undersell the West Coast price by \$.60. In other words, the value of North Slope crude oil on the West Coast as set by what the other producers are charging is \$12.63. ALPETCO is getting its oil and is willing to sell oil for \$12.60. I mean \$12.03.

I really doubt whether, out of roughly 6 to 700,000 barrels per day of Alaska crude, which can be marketed on the West Coast, they are going to push in 130 or 140,000 barrels a day of it for only a \$.60 discount. If you recall, ARCO will be moving all of its own oil through its own refineries. There is no way they could push ARCO's crude out of ARCO's refineries. EXXON

is going to be running a substantial amount of its own crude in its own refineries. Essentially, if ALPETCO is going to market this, they are going to have pretty much mop up the independent refiners who could accept the backing out of a very large portion of California independent production. And they are going to have to butt heads with SOHIO. They are going to have to undersell SOHIO at the CHEVRON refinery. Let's go back, There is no way they can sell Alaska royalty oil on the Gulf Coast. The only way they can sell it on the West Coast is to undersell SOHIO. And, essentially, they've got to undersell SOHIO at CHEVRON's refinery.

CHAIRMAN MILES:

Why would a CHEVRON refinery, an independent refinery, be willing to strike a temporary agreement with ALPETCO when they know that essentially they are going to have to go back to producers once the proposed facility starts producing petrochemicals?

DR. TUSSING:

Because there's a surplus of oil.

CHAIRMAN MILES:

Simply because of this?

DR. TUSSING:

Well, if you had a seller's market, which you don't have now and you won't have in 1980, and, very likely, you won't have in 1985. You certainly will have a buyer's market on the West Coast of the United States, at least through 1985. They are going to shop around.

Now, I'm not saying that the process is going to be perfectly competitive just because there's one seller. But now we've got a wild card in the deck. We have a different kind of seller. SOHIO will not behave competitively, will not use its full market power to capture its maximum market share on the West Coast because it knows it's spoiling its own market.

ALPETCO's in a different position, because to the extent ALPETCO drives down the West Coast price and can make a profit in doing so. Next month the composite average goes down if ALPETCO sells for \$12.03. You can see SOHIO's getting their oil cheaper than ALPETCO is. SOHIO can defend its market position. SOHIO will not initiate a price war, but SOHIO will not be backed out, either. So SOHIO will go as low as ALPETCO can go, and it can go lower for the purpose of protecting its market

share. Some of the California independents can't. And you're having this problem right now that Alaska oil is backing out California independent production. The Economic Regulatory Administration just gave an additional \$1.79 entitlement benefit, or reduced the entitlement penalty, for the California producers by \$1.79. And, thus, oil is still backing up California production. So those people, some of them can't back down. Some of them will make room for additional North Slope production, but you bet they will be in Washington and trying to get some new entitlements (indisc. - cough) or some other thing that prevents them from being backed out.

So, if ALPETCO can't afford to drive the West Coast price down to \$12.03 and still make money. Unlike SOHIO, unlike ARCO, and unlike EXXON, they don't lose a penny by doing it, because they have no stake in the production of the rest. They have no production. They are a middle-man. And, to get this market share, they will go in and compete - they will engage in what textbook economics calls arbitrage (ph). And they will make their two percent, or they will make more than two percent on the arbitrage (ph). They don't have to take the full 150,000 barrels at once. They can start with a minimum of 10,000 barrels. You find a home for 10,000 barrels today. Give me 10,000 barrels of oil today at the composite average price, and I can find a home for it in California at \$12.00. No question. I can find some California crude, or some SOHIO crude, that I can back out. So you take that next month. Meanwhile, you have driven this down a little bit and you've got a greater price advantage. Where does the process end?

If this becomes \$12.03 - the West Coast net back price becomes \$12.03 - the in-value price becomes \$11.48, and here we get another round. And, so, where the process ends....it probably won't go all the way, but the only place that brings it to a definitive halt is when the West Coast price gets down to \$10.72, which is the competitive equilibrium price. That is what your textbook economics would say is the natural price. That is the value of North Slope crude oil on the West Coast. Because, why should any producer on the West Coast accept this price, ship it to the Gulf Coast, and take a lower price if they could sell it for even a penny more on the West Coast? So the end of the process is this.

People tell me, or I have been told by people who are in these negotiations, that ALPETCO has no intention of taking this oil and marketing it. I know that Sea Train (ph) and Alaska Consolidated Shipping, which was the predecessor organization, had this as the main thrust of their participation, and they were most interested in getting an option on the royalty oil for the purpose of marketing. Now, I'm not urging any, or suggesting there's any bad faith here, I see no evidence that

any of the ALPETCO participants have ever thought this through. I know when I was on the Royalty Board the submissions (indisc.) asked of Consolidated Shipping, with respect to their proposal, were totally unrealistic because they were expecting to take oil at the in-value price and sell it on the Gulf Coast. They had professed letters of intent from purchasers on the Gulf Coast; they gave this as evidence they could do it, saying that we would take it at a price no higher than the lowest price at Prudhoe plus transportation cost.

Anyway, I don't know what their intentions are, and we'll get to how I think that the Committee ought to proceed in looking at some of these things a little later. But I can tell you that....with confidence, that just as Battelle sets out the case it would be a disaster for the state to market its own royalty crude oil, for the same reason, and perhaps even more so, a disaster if you let somebody like ALPETCO market the state's crude oil. The West Coast consumer will benefit, the national economic efficiency will benefit, but the tendency is to introduce into that market a major seller who has no stake in the business of an orderly market, who is not an oligopoly, profit maximizer.

Now, this moves on to something else. Let me put my statement to the Royalty Board in the record at some point. At that time I'd be reported on a survey I did for the Commission, mainly on the realism of ALPETCO's plans for marketing in Japan.

CHAIRMAN MILES:

Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman.

Doctor, did you say you wanted to....were willing to be interrupted before you switched to another subject?

DR. TUSSING:

Yes. Surely.

MR. CHATTERTON:

I have one question of you. This exercise we have gone through.... I think it's great, but aren't you analyzing just a small portion of the total system and not analyzing the system? Is not, with about 14 million barrels a day producible capacity today that Saudi Arabia has, and yet they're only producing about