

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 86 / 2

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8.7 million barrels per day....don't you think that they are the ones that control the West Coast price and not SOHIO? If you look at the total system?

DR. TUSSING:

If you look at the total system you see who controls the level of world prices. But the prices in individual markets vary according to transportation arrangements and local supply-demand situations. The Saudis control the price at the North Slope. If Saudis decide to cut back further on production to raise the OPEC price, the net back at the North Slope will go up. But it's not true from that to say the tax tariff doesn't determine the price on the North Slope. So, here you've got the OPEC price here at this level and, depending on the distance from Saudi Arabia and from the Persian Gulf, you'll have prices in various markets in the world like this - prices at the refineries. And then there will be other places that feed into these refineries, and you'll have to subtract transportation costs from the price there. This is the.... If this is the West Coast price, then the transportation cost from Prudhoe Bay to the West Coast influences the West Coast price. Now suppose Prudhoe Bay, plus California, put in more oil than the California can use - than the West Coast can use. That, in a sense, begins to free it from the OPEC price, because California is no longer importing OPEC oil. The only way that California price is determined by OPEC is - what is the transportation cost beyond California to the next market, which is the Gulf Coast, or to Japan? That is, it's the OPEC price in a third market that then begins to determine the Prudhoe price.

So, yes, it's true. OPEC moves the whole structure up and down. But what goes on on the West Coast of the United States determines whether this is wide or narrow and determines whether the West Coast price is above or below the OPEC price. I think it is inevitable, as long as there's a surplus on the West Coast, that the West Coast price, particularly for middle-sulfur, middle-gravity crude oil, like Prudhoe Bay crude oil, will be below the OPEC plus transportation. It's got to stay below that or we won't even absorb all the North Slope and California crude. The price situation can't be such that refiners are indifferent to whether they use Saudi twenty-seven degree, one percent sulfur crude or North Slope twenty-seven degree, one percent sulfur crude. So the West Coast price is going to be lower than the OPEC price for as long as we can forecast in the future.

I think that Battelle is reasonable in saying, we really don't want to forecast beyond 1985, because both supply and demand... there are so many uncertainties in both supply and demand. The general consensus is that world oil prices are going to go down until some time in the 80's, and then they'll start

turning up again some time in the 80's, but there's enormous disagreement about when that is. Some....the C.I.A. and Dr. Schlessinger (ph) and EXXON say 1982, there are other people who say that the crunch is like the horizon, as you get close to it it recedes because the geologists and the government officials have always, historically always, underestimated the new discoveries. The Paley (ph) Commission in 1946 had us running out of oil by 1949, the Geological Survey had us - in 1921 - running out in before 1929. That's why they set up the Naval Petroleum Reserve in Alaska, so the battleships would have some oil to run on in World War II.

Anyway, up to 1985, the West Coast price is going to be below the OPEC price - how much below the OPEC price depends on the market behavior of the producers and sellers on the West Coast, among other things. If the oil is closely held and flows through controlled channels - the North Slope oil is controlled overwhelmingly by ARCO, EXXON, and SOHIO - the effect of competition is going to be minimum. They don't have to violate anti-trust laws, they just have to behave like gentlemen toward each other. They just have to avoid getting into price wars that they know would be mutually ruinous.

The state royalty oil sold to an independent marketer has no such constraint. And, if one of the non-majors came in with a discovery out in the Western Arctic, or something like that, and it was somebody who was not tied in by intimate relationships with the (indisc.) agreement, and things like that, somebody came in with a large field - it could be Occidental, or even a major - Texaco or Gulf - they could break the market, too. Let's say that if ALPETCO attempts to move 150,000 barrels to the West Coast market, they are almost certain to break the market, and the bottom is somewhere in the vicinity of \$2.00 below the present price. Now it won't hit bottom. Maybe the SOHIO pipeline will be built which would mean the bottom would be in the vicinity of \$1.25 below the present price.

MR. GRUENING:

Does that mean that this is money that ALPETCO is going to lose if forced to sell it, so this is money to pay the state if, supposedly, they lose? Let's say they lost \$1.00 a barrel, and it takes seventy-two months, I think in the contract, before they are actually putting it in a form where it could be sold. But, as a refined product, you're talking about over \$300 million.

DR. TUSSING:

They don't lose any money. They sell it at above cost. Their cost is \$11.79. When it first comes in they can sell it on

the West Coast. The West Coast refiners are paying \$12.63 for that kind of oil.

MR. GRUENING:

You're saying that they won't prolong if they get....

DR. TUSSING:

Okay. Now the question is....the contract does not compel them to refine in Alaska or to process into petrochemicals any specific amount. So they don't reach full production. In their pro forma, their financial statement, they assume that they reach full capacity of 150,000 barrels a day in the fourth quarter of 1985. There is nothing that prevents them from continuing to sell. Suppose their petrochemical production contract is slower, and suppose they are making a good deal of money on these West Coast.... There is nothing in the contract that compels them to refine all that oil.

Now, I'm not trying to predict what they are going to do, because they don't know. I'm sure if you asked them, they'd say - well, these are the projections we're working on, but we don't know what markets will be like; we haven't even got our products laid down. But I would say, in general, that the existence of a crude-based petrochemical facility benefits Alaska in terms of the tax and royalty (indisc.).

An independent marketer very much hurts Alaska. It cannot do anything but hurt the state, and the state would be much better off to say - we'll keep the oil until you go on-stream, but we'll pay the two percent margin that you expected to earn on it. Let's just give them the money and let the producers.... The state would be far better off just handing them the two percent outright.

Okay. Well, let's go on and get back to the Alaska disadvantage. You've all heard about the Alaska disadvantage. I don't need to repeat it. You've got transportation cost disadvantages, higher construction costs, higher operating costs. And virtually everybody in the business, whether it's in the oil business or the chemical business, except this group, believes the Alaska disadvantage can't be overcome without some sort of subsidy. Now this group believes that....ALPETCO believes that it can.

I haven't worked through their economic analysis, and I don't know. I just know that it's a minority point of view. It's virtually a minority of one....

UNIDENTIFIED SPEAKER:

You've been there before.

DR. TUSSING:

No, I'm not the minority. I'm with the majority. They are the minority of one. And even their marketing consultant at the Royalty Board agreed that Joe Moore's assessment of the probability of success is fifty percent, at best - agreed that that was a fair assessment. Let's say they are going against the entire weight of industry sentiment, and I won't quarrel with that. But there is an Alaska disadvantage. Now, how can it be overcome?

The marketing plan we talked about has two elements. One is the expectation of getting long-term, hell or high-water, take or bake contracts from Japanese chemical consumers - Japanese industry. I did an investigation of this for the Commissioner and found no reason whatever to believe that there was any possibility that they would accomplish that, and I would say that the odds on that part of their program are - maybe they are finite - very close to zilch. Now it is conceivable that the notion that they can market on the West Coast....there is a substantial possibility that, given their cost structure, they can market on the West Coast. There is no basic petrochemical-producing facility on the West Coast.

Given any reasonable assumptions about economic growth, the demand will increase, and there is a gap that they could fill if they could overcome the cost disadvantages of operating in Alaska. They realize that the alternative sources for the West Coast are, for example, the Gulf Coast - the expansion of the existing petrochemical industry there - and there is part of the cost disadvantage, the transportation cost disadvantage, the transportation cost component of the Alaska disadvantage, is offset by the fact that if that crude has to go to the Gulf Coast and the products come back to the West Coast. So a West Coast petrochemicals plant would have a substantial advantage for the West Coast market over the Gulf Coast. Now it's quite conceivable, even though a California-based petrochemical facility would be in better economic shape than an Alaska one, that because of air-quality problems, site problems, it may simply be impossible to get a site for a petrochemical plant in California. So given those two considerations, they might be able to offset on the West Coast a good portion of the Alaska disadvantage.

The remainder of the equation is an interesting one - that if the West Coast price for Alaska-type crudes were substantially below world market price, below the Gulf Coast price, if there were no SOMIO pipeline, if exports to Japan weren't allowed, then we'd have a price for a North Slope crew. There would be a price advantage for a West Coast producer, whether in Alaska

or in California of a dollar more per barrel over its competition in the Gulf Coast region or, for that matter, competition on a crude- or naphtha-based facility anywhere in the world. Here's where the marketing fits in, and, again, I don't believe this is ALPETCO's game plan. But, if by marketing crude independently between now and 1985 they broke the West Coast price, pushed it down to a level \$2.00 below the world market equivalent, they would have gotten their subsidy from the state. They would have gotten that \$2.00 by the back door. Now, why, when they go on-stream, doesn't the price go back up again? And that's an interesting question. Would it go back up when they take the crude out of the crude market and start marketing petrochemicals. I suspect it's a one-way downward ratchet, because the equilibrium price - that is - the normal situation and the absence of some sort of anti-competitive behavior, is the same for all destinations at Valdez. And that the big three would have to collude, and they'd probably have to get the California independents on board. They would have to engage in per se violations of the anti-trust laws to re-establish the differential price structure. I think that once this differential price structure is knocked down by competition it would take a positive intervention - anti-competitive intervention - for the market to restore. So....

UNIDENTIFIED SPEAKER:

Dr. Tussing, just a moment. If we're talking about a time-frame of 1984-85, which is to unscrew their oil from the West Coast market, this is the time when the shortages, or the surpluses, appear to be diminishing. And if we further diminish it by 150,000, which is hypothetically injected into that under your scenario, doesn't that have to drive the price back up?

DR. TUSSING:

Well, as long as there's a surplus, there is no force driving the price back up; that is, there's a surplus now that is having downward pressure on the price. And that downward pressure is being resisted by the fact that the oil is moving in controlled channels. So long as the surplus exists, I don't think there can be any upward pressure on the price on a price structure that's been established previously by competition.

Secondly, I don't think we can count on, say, 1985 being the time in which the surplus is diminished. All we can do is say with confidence that the surplus will increase until 1985. After 1985 we don't know whether it will level off or diminish or what. So the.... I'm not trying to forecast the future.

I'm just.... The case I've established, with respect to the erosion of the price, is a worse case. As I said, I think there is a substantial possibility there will be some export outlet. For example, they could....the Federal Government could go half-way on it by allowing the export of residual oil from the West Coast. And it's the heavy high-sulfur resid which is creating a good deal of the glut. The top-end of the barrel can be used. If the California refiners could export their heavy fuel oil to the Far East, that would take a lot of.... There are things that would minimize the danger of the scenario, but the point I want to make is that the scenario which is worst for the state is best for ALPETCO in the sense that the best way of overcoming the Alaska disadvantage is with a lower price for crude. And that is one way I can see, without going dollar per dollar through their cost projections, and I'm not a chemical engineer or a cost engineer, and I can't assign costs to the various elements of their proposal, but just in broad general terms to overcome this cost differential, this is the only way I can see it working on the West Coast is they are relying on a West Coast price that's lower than the import equivalent price. And that is a way of overcoming the disadvantage. I want to repeat - I don't think that this is their game plan, because I've seen no evidence that there's been any long-term or any sophisticated view of the crude oil market on the part of their proponents. They certainly haven't put it on the record. And conversations with the participants over some time haven't betrayed any indication that this is what they are looking at. But I think that it is something the state really ought to take into consideration.

Now, if you have any more questions, I want to first ask how long you want to go.

UNIDENTIFIED SPEAKER:

I think we should just keep going.

DR. TUSSING:

Okay. One of the issues that was raised to me is....

UNIDENTIFIED SPEAKER:

Doctor, would you like to take a five-minute break?

DR. TUSSING:

Yes.

(FIVE-MINUTE BREAK)

DR. TUSSING:

I think the most important of the remaining questions is.... two of them that go together - is it possible or likely ALPETCO could get its project financed without overwhelming assurance of its commercial feasibility? And I address this one, in particular, because I think there has been an assumption all along, and certainly Commissioner Leresche stated this, that the ability to finance the project is a good test of its commercial viability and, although we of the state can't make a really accurate assessment of it, the financial community will, and their ability to put the financing together is probably the best test of its commercial viability. I would think that would be the conventional wisdom, and I address the problem only because Milton Lipton said to you that it was not necessary to demonstrate overwhelming likelihood of commercial feasibility in order to get the thing financed. But it is quite conceivable the thing could get financed and still go belly-up. I don't think he was talking about the fact that bankers and underwriters sometimes make bad judgment, but I think he was saying that it's not necessary to show that it would be profitable to get the....to obtain long-term debt. And this is true with certain assumptions about financing, with what we call conventional financing, where there's a big equity component.

The financial markets, the bond underwriters, and the insurance companies, and the other institutional investors are not interested in the profitability of the project, per se. They could care less about the health of the equity of the owners. The health of the owners....the financial health of the owners concerns them only to the extent it affects the ability of the enterprise to pay interest and to re-pay the debt.

So, in conventional financing, if there is a sufficient equity component - that is, if the owners put up enough of their own capital - it's quite possible for them to get financing. In the worst case their cash flow is going to be sufficient to cover debt service. Suppose we're going fifty percent equity and fifty percent debt - I'll just use round numbers and not say....and I'm not going to claim these are the numbers of the ALPETCO project, but just to show the principle. Suppose you have a one-billion-dollar facility. So it's \$500 million debt borrowed money. And the owner has put up \$500 million in equity. Suppose the interest is nine percent, so it's got to pay \$45 million here in interest. And it's got to pay.... Suppose it's got twenty-year life, and so it's got to pay \$25 million a year in depreciation - in amortization - in debt repayment. All right, so you've got a total of \$70 million that this company has to come up with in addition to its operating costs to pay off the debt. Now, to make money, to make it a worthwhile investment for the equity investors, they

probably have to make fifteen or, say, twenty percent before taxes, at least. So it's probably twenty-five percent before taxes. So, to make it profitable, to make it worth doing, they have to come up with a cash flow of \$195 million a year; that is, in profits, allowance for interest, and depreciation they have to come up with \$195 million a year.

The equity investors probably won't go in unless they think they can make \$195 million a year. They won't start the plant unless it shows on their pro forma statement that the cash flow is going to be \$195 million. The bond sellers will go in, and they really have to be convinced that there is for sure going to be \$70 million. And, if the \$70 million is there, the owners could be losing money every year and they are still meeting their debt obligation. So it's true that a non-profitable....that the financial community is willing to invest in projects which may turn out....which have a good possibility of turning out not to be profitable and of pouring in money and lending money to PAN AM, or Penn Central, or God knows what. All sort of Chrysler companies lose money year after year after year after year. So long as there is some security, and they'll look at it in terms of the debt service coverage. They'll say.... They'll project the income and say the cash flow is how much percent of the debt service. Now, in evaluating utility bonds you look at what is their income as a multiple of the amount of interest and repayment they have to pay.

CHAIRMAN MILES:

Dr. Tussing, the equity owners aren't going to sit by and let that happen year after year after year.

DR. TUSSING:

What can they do? What can they do? They, most likely, have a situation, and this is true of many of these companies, this is true of Chrysler, for example, where they lose money year after year. They lose more by shutting down than they do by continuing to operate. They have to.... If they shut down they still have to pay that \$70 million debt service. They still have those fixed costs.

If their revenues exceed their operating costs by even a penny, it pays to minimize your losses. And so, generally, when a facility is worth more as a going business, even to the trustees in bankruptcy.... Well, let's look at some numbers here. Suppose the fixed costs are \$250 million a year and the variable costs, that is operating costs, are \$250 million, so the total cost is \$500 million. Okay, now....suppose your revenues, that is the sales, are \$400 million with a loss of \$100 million. What happens if you shut the plant down? You do away with

570
25
2500
1000
12500
70
195

\$250 million operating costs. You reduce your costs by \$250 million. You reduce your sales by \$400 million. And so your loss goes from \$100 million to \$250 million. So what happens is these fixed costs include payments to bond holders, and so on, creditors. The same when you get the drain of \$100 year after year and pretty soon the equity of owners is wiped out. And suppose they get to the point where they can't meet their....they can't pay their operating costs? The thing goes into bankruptcy. The bond holders become the owners. And they see this enterprise can't pay \$250 million any more. What can it pay with sales of \$400 million? All it can pay \$150 million in interest and repayment. So, they take a bath on that, put the thing up for bid, and somebody buys it at a price which reflects this situation. That is, the old owners are wiped out, somebody comes in with a lower capitalization - he comes in owing less money - so he has to pay only this much.

First, in answer to the first question. With conventional financing it is possible to finance a project that has a large risk of losing money. And conventional financing is one where the owners either put up a substantial amount of equity or where this is a subsidiary corporation where the parent corporation, or somebody, is willing to guarantee the debt. So, to the first question....yes, with conventional financing where there's a substantial equity cushion, where even if the owners are losing money year after year, there's enough surplus revenue to pay the debt service. Yes, you can.

Second, in that sort of situation, the company can go on losing money for years and years and, as long as the owners, or the creditors, or the trustees in bankruptcy, or a potential other owner see that its sales are going to be more than its operating costs, it will continue operating. Now the owners may lose everything they've got, but it will continue operating. So, let's look at some of the consequences of this situation.

Suppose ALPETCO does get its financing together. Now, let's pass, for the time, on how they can do it, because they aren't proposing conventional financing. Suppose they do get the financing together and then they start losing money. Does that mean it's going to shut down....the plant is going to shut down and throw out the people who are working for it? Does it mean it can't pay its operating costs, which include the cost of feedstock, any more. No. Not so long as the sales exceed the operating costs. And in a capital-intensive operation of this sort, you really have to get into a bad situation before it pays to shut down or dump the plant before its value as scrapped is greater than its value as a going concern. So the chances of the state being compelled, from the point of view of keeping the jobs flowing, of bailing out a conventionally financed plant, are minimum.

I think the problem with ALPETCO is that its proposal is a little different. It proposes, rather than conventional financing, what is called project financing where the companies that own ALPETCO are putting up any their own faith in credit. They are not proposing to support the thing. So the bond holders have no recourse against Alaska interest. They can't take Anchorage Natural Gas; they have no recourse. They can't put a lien on Sea Train's ships, they can't put a lien on a native corporation's lands or future income, or anything of that sort. So, their only recourse is against the project itself. So they are going to look with even greater scrutiny than they would at the income statement and whether there is enough income to cover the debt service. Again, the problem here is that the owners don't propose to put up any capital. They propose one-hundred percent debt financing, or, if I read it correctly, there is something like a hundred....seven percent financing. When the thing goes on-stream the facility will have a negative net worth. That is, they will owe more than the plant is worth. And so the only security....the thing that they have to do, since there is no security in terms of an equity cushion, say all the cash flow has to be available for debt repayment - there is no equity cushion - they're not taking any bath, there's no recourse against the owners. Then what is absolutely essential is there be somebody that they can have recourse against. Well, I've convinced the Commissioner and his staff of adequately protecting the state against any legal recourse against the state, or against its revenues, or its royalty oil.

The only other alternative is that the sponsors get these take-or-pay, these iron-clad, hell-or-high water contracts where they have contracts with credit with the purchasers; that is, major chemical companies whose contracts are bankable. And these contracts may not have a fixed price, but they assure that have a....called hell-or-high water, or it's like the (indisc.) tariff we were talking about last year with respect to the gas pipeline where the purchasers have to promise, have to contract, to put up enough money, regardless of whether the plant is on-stream, whether it's producing, whether the producers are able to re-market the product to cover the debt service. Now it may be a formula price for the final price is determined by the world market price, or an index, or something like that. But there is no way that you are going to get institutional investors to go a hundred percent, or even seventy-five percent debt. In project financing, again, there's no recourse against the owners. Project financing....there's no way that the institutional investors will do that unless there are contracts that will provide for an assured revenue stream equal to the debt service charge - to the interest and amortization.

So, I'd say I don't know what Milton Lipton, what the assump-

tion of the questions to him, but I would say that the conventional wisdom is more right in this case; that is, that unless they can show the (indisc. - cough) that they've got contracts to sell the stuff, and contracts that are enforceable against credit-worthy purchases, then they are not going to be able to put it together. And I think that's what they've been saying....that ALPETCO's been saying all along. And their ability to finance the project is a measure of viability. If, for example, as against the conventional wisdom in the oil and chemical industry, and practically everybody I've talked to, going against that they are able to execute hell-or-high water contracts for the sale of their product, they will be financed. And they've got no marketability problem. They will be profitable because they have no equity to.... their rate of return on equity will be infinite regardless of how much money they make. So, if they can get it financed, they'll get it financed according to the plan here. If it's going to be project-financed a hundred percent debt, the only way they can do it with hell-or-high water contracts for most of their proposed output, and, if they've got that, they are home-free. They're not going to come back to the state and ask for special deals.

MR. PARR:

Dr. Tussing, what you are saying is if they have assured sale contracts....

DR. TUSSING:

Yes....

MR. PARR:

....they have an assured supply of raw material feedstock from the state, and they've got a physical plant, the bond holders aren't risking very much.

DR. TUSSING:

That's right. Well, they don't even have to have a physical plant. I think that they have to have the kind of hell-or-high water contract that as of such and such a date the purchasers will pay as if they were receiving the product even if they aren't. This is like (indisc.) Gas was proposing and El Paso was proposing for the pipeline financing; that the customers would start paying for the project and would start paying off the bond holders even if the thing were never finished. Say, they don't need the plant but they shouldn't have trouble getting the plant. They could run into cost overruns. That's a danger. And there are lots of scenarios in which I'd insist in coming back to the state for assistance

And, if it were conventionally financed, the risks on the state would be minimal because that equity cushion would allow them to operate at a book loss for years and years without laying off employees or without needing to have a discount from the state.

I just don't see where they are going to get these contracts. And practically nobody I've talked to, except those associated with the project, think that they can do it. But I think the argument, and the approach of the administration, is what harm does it do to give them the chance? To give them a hunting license to go out and look for those contracts. If they can get the contracts, if they can get the financing, the state is ahead. If they can't, all we've lost is the time and the effort of the state officials and the Legislature in going over it.

MR. PARR:

Dr. Tussing, you said a minute ago that with conventional financing the state didn't have anything to worry about. By implication, one could assume that on this project financing we do. But, in actual fact, if isn't making it, the bond holders would take over to keep the operation running to get their money back. Isn't that correct?

DR. TUSSING:

Well, that's the most likely.

MR. PARR:

In other words, I'm thinking in terms of the loss of jobs and so forth and the dangers of (indisc.).

DR. TUSSING:

I don't want to say there is no danger of loss of jobs, because it is conceivable if we move into the middle 1980's with a big world surplus of petrochemical-producing facilities everybody else is going to be looking at operating costs, and we're going to have new plants on-stream in Saudi Arabia where they can back down the feedstock costs, where the Saudi government owns fifty percent of it. And, in order to minimize their losses, they're willing to cut back on the feedstock cost to cost of production, which may be forty cents per million B.T.U. or something like that. So, in that situation, you've got two things. Who's got the lowest operating costs, and this plant will certainly not have the lowest operating costs worldwide, and who's got the contractual market to share? Again, if the purchasers go on for twenty-year contracts, hell-or-high water, and the purchasers are credit worthy, they are

the biggest chemical companies in the United States or Japan, or wherever, then you really can't ask for better security and the dangers are normal commercial risks. I don't think there's any exceptional danger in it.

Now, on the other hand, let's look at some of the things that are likely to happen if they run into problems, if this group does not make its schedule. It's not going to roll over and play dead and say that well, sorry, that's the way.... you lose some....you lose a few, you win a few.

The first thing they're going to do, and they are going to do it whether they get into trouble or not, is they are going to go to municipalities or to the state and ask for industrial development bonds to finance their terminal facilities. It's ridiculous not to, because you can get a tax-free rate on.... and the City of Valdez did it with the terminal there.... And they can go to the City of Noorvik (ph), for that matter. It needn't be the City of Valdez, it needn't be where the terminal is, to get Noorvik (ph) to issue industrial development bonds rather than bonds which will be evaluated on the basis of the project. And they'll sell them the tax-free market. The City of Noorvik (ph) will get a fifty-thousand-dollar commission, or something like that. And, so, that's the first type of aid. Well, it seems to be costless unless the project goes belly-up. Unless it can't meet the bond obligation, the state has no legal obligation to come to the rescue of that, and it's just that Noorvik (ph) will never be able to sell any bonds again in the future, and the state will feel a moral obligation because if Noorvik (ph) defaults on \$350 million dollars of industrial development bonds, it's going to affect the state's rate.

So, they're going to ask for that, and they're going to get it. They're going to find some jurisdiction in the state who will take the fifty thousand dollars. There's no question. And there's a certain amount of risk. For Noorvik (ph) if it couldn't be a better deal, or whatever, it couldn't be a better deal. They will ask for that, and they will get it. So, that's the first additional aid, and they are going to get that whether they get in trouble or not. There is no question in my mind they will.... I don't know - have you started talking to people about industrial development bonds?

CHAIRMAN MILES:

Anyone want to comment on that?

DR. TUSSING:

Well, maybe that's unfair....

CHAIRMAN MILES:

Yeah, I'd prefer to comment on all your (indisc.).

DR. TUSSING:

I don't know that they have, but they'll start soon enough.

What other assistance? Suppose they're just a tad from getting the financing together. They've got eighty-five percent of it. and you're going to be here like the Northwest Alaska pipeline. We need the back-stopping to put us over. After all, we have demonstrated that the benefits to the state are enormous. And, look, they are paying 10.9 percent interest on this last bit. The earnings on the permanent fund portfolio is 8.3 percent, something like that. If the state buys their bonds at 9 percent, or markets their bonds, or guarantees 15 percent of them for a commission, how can you lose?

Otherwise, we're going to lose this multi-billion-dollar project and all of these four-hundred, or four-thousand, jobs. And so, it's an offer that's very, very hard to resist. It doesn't require.... If it's the permanent fund, the permanent fund managers look at this as a straight commercial decision. It meets the constitutional requirements for the permanent fund investments, and it will probably meet the statutory requirements. And it can be done without a vote of the Legislature and a vote of the people, unless the Legislature wants to say that no single investment of the permanent fund for certain.... But, that's the next thing.

Now, suppose the facility gets financed and gets into trouble. We have the same kind of thing. I'm not saying these are going to happen, but, you understand, the owners with their commitments are not going to, at some point, say well, we haven't made the schedule, or we haven't made the financing, or that's the way the ball bounces, or we're losing a million dollars a year - that's the way the ball bounces. And, so politically, they've signed a loyalty oath they're not going to ask for a reduction in the well head price, and there are certain moral commitments on the part of the state government to the people that they are not going to do it. So, how about re-financing? How about re-financing the thing? We're paying 10.9 percent. We can show....our pro forma shows that we'll break even. Otherwise we are going to be in bankruptcy and we're going to shut down, and so on. Would you....would the permanent fund re-finance our debt? Well, at that point we've bought the whole package and it's all sort of a re-finance (indisc.). This has happened time and again, not with these people, but with local industrial facilities. And I think if you haven't read the history of the (indisc.) Refinery in

Orin - Bay-Chance

Newfoundland, there are some very disruptive....terrible. So, again, I don't know whether these risks are excessive. I haven't calculated the benefit to the state of this project. And if it went through, if the ALPETCO people's optimism is justified, the benefits would be significant. I don't deny that, and I don't condemn them for wanting to draw to an inside straight when the ante is so low in the pot and the pot is so big. But these are things you've got to consider.

One remark that might be a concluding one in this respect - what the significance of the whole project is. I believe that the Administration, that the Governor and Commissioner, have tried to give Alaska what the polls, and what the Alaska Forum, and what the Legislature has indicated the people want. That is, we want a petrochemical plant, but we don't want to pay for it.

All the assembled industrial wisdom, all the big oil companies, the big chemical companies, and all our consultants say they can't do it. It can't be done. Here you've got one company, one group of people, who says it can be done. So, why not give them a chance? That's fundamentally what the Administration's logic is. And, if you buy that logic, I think it's nit-picking to talk about the question of pledging undiscovered oil or the option on the rest of the royalty oil. We have nothing to give. All we have to give them is high costs, a horrible logistical place from the point of view of transportation costs - that's high labor costs, high construction costs, a god-awful climate that makes it harder to operate these things, and we've got some oil an assured supply of which is worth nothing now; that is, there is no premium for an assured supply. And these people are willing to come in.... I'm sorry they left, because (indisc. - laughter). They're willing to come in and gamble more time and money than the state has putting together this....I think it's pie-in-the-sky. They're willing to take a chance, and the Governor is saying to you well, what harm is it?

It is not true that it is a riskless contract. It's not true that it's a perfect contract given all things. But since we're unwilling to give them anything on outright, they're going to get every little fringe benefit they can. Nobody else has ever thought of the state furnishing them fill for the pipeline and the bottoms of the tanks. Well, we'll give them that. We'll give them the right to veto any other project we intend to use royalty oil for. But we read the fine print and we take it back, because it's on the same terms and conditions as the others. But we've given them a lot of things that seem like gold-plating. But, after all, we're not giving them anything else, and they've got all the odds against them.

So, if you want a petrochemical for cheap, for nothing, you probably won't get it with this contract. You probably won't get a better contract that's going to give you one. You've got a chance at it. As I said, I think the....giving them the right to sell royalty oil in advance of building a plant is dangerous. It's particularly dangerous, if, as is likely, the state's position on the value of oil is not upheld - the (indisc.) formula in the back of the contract does not prevail. Because the spread among prices is going to be greater.

But, other than that, and say you want something for nothing, you get what you pay for.

CHAIRMAN MILES:

Dr. Tussing, your most recent remarks seem to discount the fact....or discount it as being important the fact of an assured supply. We've heard quite contrary testimony to that. Could you go through your reasoning again on that?

DR. TUSSING:

Right now, and at least for the next five to eight years, there is a buyer's market in crude oil world-wide. There is an enormous surplus of crude oil-producing capacity. But right now nobody will pay a premium for an assured supply. A long-term contract is worth less than a short-term contract, because a long-term contract pins the buyer down to a single source of supply when it's in his advantage to shop around in this market. Now what the other people have been saying is that sometime in the future the world crude oil demand is going to overtake producing capacity, and supplies will get tight. And, as a hedge against that time, a supply contract going out in the future may have some premium value.

Now, the present does reflect future expectations, but people give lip service to the value of an assured supply in the future but they're not willing to pay anything for it. And, again, that tells you whether they're really serious or not. You can....nobody will pay premium over the OPEC price to any of the OPEC countries in exchange for a secure supply. And, in fact, the OPEC countries have to accept a discount against the price to get a guaranteed long-term off-taker.

CHAIRMAN MILES:

Under that line of reasoning, though, it would seem that what you're saying is that it may be wise to delay this decision until the surplus is reduced or the shortage is intensified, however you might want to term it.

DR. TUSSING:

Well, the surplus may increase and the price go down. The thing is that ALPETCO is guaranteed against that if the price goes down with everybody else's. So you're not taking advantage.

Two years ago....three years ago people were panicked and they still remember the embargo, and you probably could have gotten a premium for a long-term supply, and you probably could have gotten.... In fact, I think the Alaska Petroleum Company, the Coastal State subsidiary, was willing to offer....two years ago was willing to offer a premium for a long-term supply contract. And a premium over the in-value price, and that reflected the perceptions then. Now there's still some hang-over from the embargo, but it seems to me that what people are legitimately concerned about in the future is, not reliability of supply, but price. That is, as virtually nobody anticipates another embargo for a whole series of reasons, even when the supply gets tight again. By that time all the OPEC countries will have been so co-opted into the world capital system they will such enormous domestic import demand, they will be so integrally tied in with the Western financial system that they just wouldn't....that it's almost out of the question they'd participate in something like that. There are a whole number of reasons why what people are concerned about is if the price turns up again. And, unless you give a fixed price contract.... I don't even know whether you could get somebody to pay a premium for a fixed price contract, because the world oil prices are going down now. And virtually nobody expects them to go up faster than inflation until.... for the next five years, at minimum. The question is - when does it turn up? And that depends on a lot of things that we can't predict.

Now the ALPETCO group is operating on the premise that there are chemical purchasers, particularly in Japan, that will offer a premium for an assured supply of petrochemicals. I think they're a minority of one in that respect. They may be right, but none of the major chemical companies and none of the major oil companies believe. And they're going to have to beat their way into a market which is pretty much tied up by the majors already and in competition with a great number of new petrochemical facilities that are going in in OPEC countries and in third-world countries that want to have them for just the same reasons Alaska does. They want them for diversification of their economies, they want to create jobs, they want it as a symbol of national prestige, and in every case that I've looked at they are willing to subsidize. So they're willing to take a substantial amount of the risk. In Saudi Arabia, Saudi enterprises are taking fifty percent of the thing.

In Korea, which has no feedstock advantage, the Korean government is undertaking to back-stop them on any operating losses. In Singapore, again, there seems to be....the government seems to be willing to share the risk. In Iran the government is contributing the feedstocks as its equity. And so, then, if there's a they are in a position to do so. So we're looking at competition in the world market with a lot of jurisdictions where they're willing to offer something more than Alaska is to beat their way into the market. And there's a large ethylene-producing surplus in the world today. All the projections show that it will be greater in 1980 than it is today. Now that that surplus would be worked off in 1985 if we have normal rates of growth and if no new facilities are planned in other countries between now and then.

So, I don't know whether it pays to.... If these people will take the crude, and if they can get these hell-or-high water contracts, and get the thing financed, this may be the last chance. Now, if they tell you it's the last chance, that means they know they're in a sliding market. If they told you you'd better do it now or you'll never be able to do it again, they would suggest they have the conventional view of the wisdom of the project and that they'd better convince the bankers before the bankers know what's really happening to the market. too. But, as I say, it's....I don't know....

MR. PARR:

Let me ask you.... One of the previous witnesses of the day, I made this statement and the answer was yes. About the time this project should go on-line in 1983 you'll have a seller's market. Now, you just referred to a buyer's market. And the answer was yes. This was another one of the expert witnesses. Do you disagree with that, or are you agreed?

DR. TUSSING:

No, I would say that is the earliest possible....and I suspect it will be much later than that.

MR. PARR:

Well, that's when the facility goes on line?

DR. TUSSING:

Okay. Okay. But the state's not getting any premium for this oil. If it was going to be a buyer's market in 1983, a seller's market in 1983, in which security of supply becomes important, then your conclusion would.... If that's the case, then the state would do better not to sell its oil under terms now that

it gets only the in-value price.

MR. PARR:

That leads to my second point, then. You said that oil prices are going down. I'm not an economist, but I understood that we were using more oil than is being produced - supply and demand should be driving the oil prices up, not this year and I don't say next year, but isn't the long-range thing that involve prices like everything else be going up?

DR. TUSSING:

Well....

MR. PARR:

....and the more that the demand outstrips the supply, the more they'll go up?

DR. TUSSING:

Well, demand is not outstripping supply now.

MR. PARR:

This year, this year.

DR. TUSSING:

This year or next year. So, until the mid-80's, sometime in the mid-80's at the earliest, the pressures on world oil prices will be down. I think there's pretty general agreement that until 1982 or 1983 there are not going to be any increases in the world price of oil above the rate of general inflation.

How long after that it goes you get the C.I.A. saying 1983, and you get the U.N. saying 2,000, and there are other people who say that it's like the horizon - the closer you get to it, it withdraws. Say, if you get out past 1990, not only are the.... there may be large developments of conventional oil but, if these high prices maintain all that time, we end up re-defining petroleum, or changing our definition of petroleum.

There are three deposits of heavy hydro-carbons in the Western Hemisphere that I can name, and there may be others, each of which have more oil in them than all the conventional crude reserves of conventional oil in the world. Any one of them - they're all in the vicinity of a trillion barrels of crude reserves - the (indisc.) tar sands, the Colorado oil shales, the Orinoco (ph) tar belt in Venezuela. Those have not been economic resources in the past because it's always been far cheaper to produce or purchase....

/Whereupon the tape recorder apparently ran out of tape/

I don't see anything the state gains by selling now on a long-term contract at the in-value price, because they are going to get that anyway. In terms of selling, the state is not getting any premium for the long-term sale. The state may get a petrochemical plant. I personally doubt it, but it may get a petrochemical plant. Now, if it wants it, it's got to take some risks. Any enterprise that comes in, whether it uses state royalty oil or anything else, is going to ask to be bailed out if it gets into trouble. If ALPETCO went to SOHIO....incidentally, if SOHIO's oil is cheaper than in-value price, SOHIO's really got a problem. Ask them why they don't try to buy it from SOHIO. Well, because of the political involvement of the state it has a symbolic value, and the state selling its royalty oil may.... SOHIO probably just doesn't believe that the thing's got any potential and won't be involved in it, but they would do better going to.... Suppose they did go to SOHIO and got the oil and got a jump. If they got in trouble they'd still come to the state, whether it's the state royalty oil or not. If they couldn't meet the debt service, they would come to the permanent fund and ask for re-financing. Here this project for, what is it, four-thousand jobs, and they had that last fifteen percent of financing to put together, and they were buying SOHIO's oil, of course they'd come. Or, if you've got a big bottom-fish processing plant, they've evidently got no objections to the state taking some of the risks and providing capital subsidies for bottom fisheries. So, what's so sacred about something that uses the royalty oil? Every business is going to have to be bailed out, and we're going to have the pot full of money to bail them out with. The risks to the state on ALPETCO aren't that much worse than the risks on anything else.

Let me wind up with one thing....with one suggestion to the Committee. One of my terms of reference here was how the Legislature does resolve the actual legal, analytical policy questions presented by the contract. When I was working in U. S. Senate in the Energy Committee, the Interior Committee, we had a procedure for hearings of this sort in which the staff would make up a long series of written interrogatories organized into the factual questions, the statistical background, things like that, legal questions, analytical questions, and things like projection of future trends and how things work, and policy questions. And these could run....sometimes there would be four or five questions, sometimes there would be four or five pages of questions, and the witnesses, governmental witnesses or the industry witnesses, would be sent these over the signature of the Chairman some weeks in advance, or

far enough in advance of the hearing as was practical. At the same time the hearing was scheduled the interrogatories would be published along with the official notice of the hearing. Then the witness would be required to bring a prepared statement responsive to these things and to deliver it to the Committee twenty-four hours before they appeared.... before the witness appeared. So, again, the members of the staff would have a chance to look at it, because a lot of the questions revolved around very difficult legal points or complex statistical and analytical problems that you really can't cope with just off the top of your head, and which the witness can't cope with off the top of his head. At the same time you get the witness on the record as to what he means and it's very difficult for him to back out or change his premise.

Now, this would be particularly useful with this contract where there is some....the question, what does the contract mean. Section 2.3 has the phrase....ALPETCO can exercise its option to purchase as under circumstances which are triggered by a proposal to offer the oil for sale to another purchaser at a lower price. Well, what is proposed to be offered mean? Does that mean the Commissioner has simply asked for proposals? Now, some people say we need a fancy legal expert to do this. You don't need a fancy legal expert to find out what that means. Because, if the thing gets to court, if it's ever going to be litigated, if it gets to court, what does the judge want to know? The judge wants to know what is the intention. What did the contracting parties intend by this? He doesn't go to his legal dictionary and look up propose to be awkward. He goes to the men of the Royalty Board or he takes testimony from the two parties as to what was said in negotiations, and they present whatever they can. And, so, if you ask the question, if you have a series of interrogatories and say, what does this mean - does it mean that such and such? - and you ask both the Administration and ALPETCO to answer it, either they get together on the answer, which is perfectly proper, in which case they give you an answer, and you know what that means. Henceforth, that is what it means. Because if anybody questions it, the other side just goes into court and say before the Joint Committee of State Legislature they say their understanding of it was this. So, that's what it means. If they come up with different answers, and it's a serious thing, you've got to reject the contract because you can't ratify a contract when the two contracting parties don't agree on its meaning.

This list of questions prepared by Legislative Affairs, questions to be answered in these hearings, is exactly the kind of thing you've got in mind. They've got to be sharpened, but there are some very good questions in there that are going to fall between the cracks in this hearing. Or, for instance,

Fred (indisc.) will tell the Chairman the answer to one of them. But he's not on a public record in such a way that you've also asked ALPETCO the same question, or, if it's a question having to do with what's going to happen under what circumstances where you've asked the consultants to respond to the same thing on the record where you can compare their answers. And I would strongly suggest that you get your Committee staff, or Legislative Affairs, to put together a series of questions of this sort which can be directed, above all, to the two sides that are contracting this but, also, to the extent they're appropriate, can be directed to the consultants. And you can ask the consultants, to within their particular competence, to respond to these various questions.

CHAIRMAN MILES:

Are there any questions for Dr. Tussing?

Thank you very much. It was exciting and enlightening.

Saturday

3/18/78

Talk conferencing

① Take testimony from witnesses in
Juneau

② One witness from witnesses
in Anch, Fbbs, Nome

- Rice + Berman's testimony (Trustees
of Alaska) in the record

- Tussing to Royalty Board testimony

Howig -

Risk involved and

Rewards

Subsidies

Subsidies

Reduced Price

70% Prov.

90% Prov.

Risks (+ Rewards)

Not term Risks

1. Flood CA with crude oil (Fussing)

AGO 545658 +

Scenario remote

2. Unable to put project together with 18 mcs.

Near Term Rewards

1. Employment
2. Construction

Long Term Risks

1. Plant built & running
Then ALPETCO can keep
it operating profitable
Risk accrues to ALPETCO
Risk is minimal
for ALPETCO to get financing,

Rewards

Jobs
Construction
Investment
Profits of Endowment Trust

all we want is "the opportunity to
try"

Miles: Subsidy Question:

- Line item requirement
- Price Change/Reduction

9 MM

Howey:

- Could be viewed as a subsidy. However, more "an investment" than subsidy. Not a lot of money relative to the total contract

- Gov's insistence, -
A strength rather than
weakness

Miles:

Nevertheless, the reduction
is a real possibility

Chatterton:

at what time can APETCO
take the interest under
10.2(d) and

Financing Question:

Not just capability to
borrow the 1.5 bln but
a commitment.

Miles: Cost of facility

Howie: Rough estimate
incl offsite
dock
utility 2.5 billion

Miles: why is it not mentioned
in the contract?

- Howie:
1. Facility must be
"phased in" -
 2. adm. wanted the
benchmarks so they
are attainable - so
they don't have
to come back
to Cong. - hope to
do better

Before it's over we will
probably spend more
than 2.5 bln.

Chatterton: Article 13 - Brokerage Clause
anything over 30M can
be disposed of at
ALPETCO's discretion

Howig: ^{of presentation} Pg 21 - "Core" Refinery
includes feeding
the Aromatics
Plant + Feed
Separation Plant.
It will have to
serve more than
the 30 M/bbls.

Brokering of crude oil
for ACS benefit - that's
the main reason for
the interim oil

Miller: ^{can} What if we do that Alaska
did not do to assure
max Alaska employment.

Howig: ① 34,000 reasons - the natives
in this venture.

② Facility in one place
instead of being strung
out. People on construction
will wind up as
permanent employment
(86% of new employees
required for enlargement
of Colli or where Alaskans).

Testimony

Fchs - 2

Name -

Are - 1

Fchs: Witnesses

① Dr Wm. Wood - Former Uo/A Pres.

Appraised the proposal

ALPETO proposal for people
of Alaska.

Jobs -

② Mr Terry Rauter Peloser

Public Impact by public during
negotiations

2.2 } to be included in NPR

2.4 }

4.2 } Commitment to 2.5 bln

4.3 }

2.2.2 Add infinitum

4.4 Endowment - future

5, 6, 7, 8 + 9 } ALPETO
13 } Capitalizing at
Alaska's expense

10.3

25.2

am change:

Jerry McCutcheon

- * - Contract still under neg. as ~~early~~ late as early this week
- Legal - prior finding
 - dedicating future reserves.

Issues not addressed by Royalty Bd.

- Neg. other than at arm's length
- Reduction prov. - ALPETCO surely will go for reduction
- As much money should be spent to defeat reduction as for reduction
- If contract were renegot. larger and more assured bidders would emerge
- What's the hurry - Scoog asking for delay for 2 year.
- Fin. letters of commitments - totally meaningless - must be included!!
- CA flooding with high sulphur crude - reopening the trade option - who would get the profits?

Doscher & Daugherty report not
the final report - ~~is~~
certain sections will be
strengthened

advise
Mike
Miller

Contract still under neg.

Reliable source at the RB
hearing yesterday

Call the Adm. and ask them!

Henry Pratt -

- No scare tactics have been used
so far

- Participation has been high

- Legislature can be first to have
the honor ~~to~~ to lay the base
for industrial development.

Chatterton: The mtgs with ALPETCO members
and Gov in Fbks and Enc -
Pls check if question of
contract modification was
raised. Horig said - not
this knowledge.

AGO 545665

3/20/78

Questions to ask ALPETCO people

① Barbour Oil

Bohiller

- Current production?
- Pricing tier?
- Location of production?

Rogers: Not available. Unknown. John Barbour transferred all interest in his leases to his father the day before he left for Japan. Rogers believes that none of the leases are producing.

② Price Refinery (Subsidiary of Seatrium)

Bohiller

- Current production? 36,500 b/d (July)
- Pricing tier?
- Location of production? via pipeline from Texas >

contact
Brown + Root (Gary Montgomery - Houston)
would probably be able to provide
information. Kathy Chandler to
have Montgomery get in touch
with me or get his no. for me!

③ Export of products to Japan.
Battelle (Raised by Marc C of Battelle - the
"unlikelihood" that it would be
permitted).

Rogers: Bill VanNess opinion - Will send
copy - also products which can
be exported listed in CCH Export
Reporter (ask Bob Maynard)

④ Has contract been physically been
signed?

Rogers: Yes

⑤ 5.3 Where is the storage?
North Slope? North Slope +
Valdez?

Rogers: Unclear

Eddy Rogers - Kathy Chandler
Hank Paratt

3/20/78

Rep: MCK

Mollister - Not affiliated with ALPETCO

Mills: Where in contract that 150M has to be processed

R: No requirement

Mck: If refinery would only use 120,000 b/d, would we be obligated to purchase 150,000

R: Yes but would probably not call on it unless needed for storage. Unlikely that they will ever take interim oil

Mills: 90% option - Reaffirmed earlier testimony that their concern is that a lower price would "destroy a competitive price"

R - will be able to get cheaper oil by virtue of lesser transportation charges

Kay
→
"lower adjusted price"

- all conditions attached to a sale would apply (refinery, on Horns Spit)

AGO 545668

Chatterton: Where can you show me in the contract that the contract and petrochemical plant has to be built without ~~you~~ breaking the terms of the contract.

Chal's
scenario

30 b/d refinery capacity

{ 20% credit

30 Mth/d processed

120 M shipped south

R

10.2

Randy B: What does "commit to expend the means" in this context?

R

obligatory (tape 18107)

R

10.2 not considered a breach or default

Chatterton:

If you do not meet benchmarks in 10.2

we can terminate - unequivocally?

R

Yes - In addition State can cancel under 4.2 if

Petrochemical facility has not been built.

Concessions

Miles: ① Where did LeResche not give

90% - 85 + 5? 90

90 - 90

90 - 70

② Point of Delivery Point
Volder W. P.S. #1

③ Charitable Foundation
4.4 definitional problems
affiliates



② 8.2 - in-kind ID in-value
Cost to ALPETCO

Miles: Article 12 - Commitment? To what extent?

Letter of Credit - Funds up
to amt. promised, issued by bank.
blank check up to the
face ^{amt} of value.

Thursday

3/23/78

Administration

Barnes + Paul Maynard

- Purchaser - Supplier Relationship Provision
- Whereas Clauses
- "Indirect Beneficial Shareholder"
Sea trains - not directly involved
- a second line corporate board

Charter Attribution

- p 42 14.3 - whose language is that?

Frederic

Accepted

Ch p 43 15.1, 2, 3 whose language

Frederic

A combination

Charter Attribution: A mutually agreed

upon article

For

Yes!

Ch:

p 32 10.2 (3) 18 mos prov.
not too diff to meet
that bench mark

Have they achieved
the step where they
can take the royalty
oil?

For

Yes

Ch:

p 33 10.2 (5) 30 mos prov
commence construction
of facility -

It is conceivable at this
point

by definition I submit that
this would be a 30,000 b/d
refinery - a portion of
world scale petrochemical plant

- the royalty oil (150M)
- this is as far as ALPETCO
will go

- not go further
- If they take this position
and I refuse to meet
any further
benchmarks, how can

the state terminate contract?

For

Yes
p14 - energy, aromatics,
olefins, etc

a 30M refinery for energy
fuels (4.2.2) will not
satisfy olefins, aromatics, etc

Ch:

Under this scenario, ALPETCO
says "I disagree and I
see you in the greenhouse"
and furthermore I will
not perform under
the tender conditions

For:

Contract will terminate
under article 10

Ch:

now let's talk about
14.3 - materially up Breach
No default has occurred
where you suffer no
economic loss.

AGO 545673

For:

One of the purposes is
that one of the material

performance benchmarks is to
submit and operate in facility.
- If benchmarks are not
met, is not a breach
but default

Q: - force majeure clause seems
to back them out - defense
line is wide enough
to drive sev. banks
through

For: I find it hard to believe that
force majeure could apply,
since it must be beyond
their control.

For: Non-compliance, to borrow
money is not grounds
for force majeure.

Ch: What about EIS or docking fee.

For: That's more likely to happen
but not applicable since
if they submit a
EIS for 304 b/d ref. AGO 545674
it is not in compliance
with 10.2

Q: You feel comfortable then?

Fr: Yes

McK: Expend or commit to
expend

Fr: Problem they had
and which we
recognized (listen to
tape)

Fr: Difficulty to get financing
to commit what you
promised to do will
not be covered in ad-
verse may well.

Malco: 30M of in-state funds -
no requirement to
produce 150M
- No requirement to
produce 30M either?

Fr: I can't shed any
light on that
struggled with
language - we
bumped into
lot of problems
anti-trust - this

language is far as we
could go

It was our conclusion
that if the fee was
here and the milk
was here, the incentive
would be there for
— I was unable to come
up with a solution

M.les — What about processing?
Candy!

— If you build a fee you
have to put out through
No banker would allow
them to ~~exit~~ ^{exit} (H)
~~exit~~ ^{exit}

M What about using another
feed stock rather than oil?

FW Doubt that they could
get by without running
one through that refinery
However, no prov. has
run 150 M b through
~~refinery~~ refinery; wit
I just don't think it's

economically viable!

Ch: 2.2 vs. last sentence of
2.1.1

For: "Settlement" in court suit
rather than judicial determina-
tion!

Ch: What length of time is involved?

For: 2-3 yrs, may be less!

Notes: Article 6 of 2.3 - quality -

Ch: Production decline after 1980 -
Rate rapid!

ALPETCO - first refusal on all
future royalty oil?

For:

Ch: The possibility that new field
could come on stream that
would even keep up with
the decline of PE is
uncomprehensible to
me!

McK: Same terms + some
conditions (2.3)

(Houma Sp. Refinery)

Scenario asked of ALPETO

For: Now contemplated this
Have to meet the/all
~~the~~ the conditions.

Mike: What ^{about} reduction in the
ALPETO facility?

For: To prevent another fac coming
on line with cheaper feedstock!
- Yes, it would probably be
in ALPETO's interest to take
2.3 option, even with
strings attached, even
if they have to shut
down 1st fac. since they
get out cheaper.

For: How do you know that we are
well protected - loopholes?

For: Looked at other contracts
of this nature; and extensive
review by lots of people
ALPETO's review is
also helpful as far as
their benefit.

Part: 70% clause - involved?
leases with little "C" - references
in contract

Miles: Future lease terms would
work advantageously for
State

Part: Brantford leases would
come under 70% prov.

EXCERPT FROM THE TESTIMONY OF JOE MOORE

April 5, 1978

CHAIRMAN MILES:

Joe, a couple of questions, I think, -- if you could put on your oil consultant hat for a moment. How serious is the possibility that the royalty oil contract will short circuit any gas, any possibilities of in-state gas process?

You seem to indicate that --

MR. MOORE:

Putting it in that sequence, I don't think it would make any difference.

That is if the royalty oil contract is approved and the process goes along, as I assume it will be scheduled to go along. I would estimate that a substantial chemical company, if they could be interested in the utilization of gas for a chemical plant -- I think that they would not consider the royalty oil contract as being inhibitive there. I think they would look at it as a certainty.

CHAIRMAN MILES:

Okay, that's what I don't understand. If there's going to be marketing problems of the two facilities; one facility is essentially substantially less expensive to build, it seems like there's going to be a problem downstream.

MR. MOORE:

Well I guess if you think about the ALPETCO cake as (Indiscernible) as ALPETCO has said, they're not committed to any particular product slate and in order for ALPETCO to build the plan on the scale that they have envisioned, that they have indicated that they would build, they have not built -- their investment schedule envisions building a big petrochemical plant. They could build something that would otherwise meet the state's criteria, having built something significant for a lot less -- ~~say~~ a billion and a half I think is their first cutoff point. Now what that really does, it ties them into building something pretty darn elaborate. (Indisc.) Now to build that petrochemical plant they have got to in some way market this product in a market which they participate. They have to penetrate a market that they're not involved in, that they're not in right now. I suppose that their strategy really would be that this penetration would be through some kind of joint venture. I don't know this, I'm just interpreting what I think I've heard ~~Hugh~~ ^{Paul} Spitz and Gordon Caine say, that they would be looking for people who are presently in that market but who would come in as some kind of a joint venture on the

plan with ALPETCO. Now if that were the case, then a joint venture partner would be -- well there would be ARCO, there would be EXXON, it would be SHELL, it would be GULF, it would be CARBIDE, it would be MONSANTO (ph) or it would be DOW. Now I don't think any of those people would go into partners with ALPETCO.

CHAIRMAN MILES:

Where does that leave ALPETCO then? Insofar as proceeding with the contract.

MR. MOORE:

I think to proceed on the full scale that they envision, I think they have real problems as I have said in my report. They may proceed -- they may very well find that niche that they can proceed on and I think it's fair to say that their thinking is probably pretty wide open on that point. But the project that was proposed originally by John Barbour which I think is the only really written version we have seen with the scope of what the ALPETCO project would be -- I think they can't do that. Now I'm not saying they can't do something, but I don't think they can do that.

CHAIRMAN MILES:

Well what do you envision them doing?

MR. MOORE:

Well it would be feasible for them to build a fuel refinery and a third stage to which they would start adding some petrochemical operations.

CHAIRMAN MILES:

Based on crude oil or --

MR. MOORE:

Yeah, crude oil. I mean let's just take -- forgetting the gas for just a moment, let's just take one of the scenarios which is most likely of success for ALPETCO. Well I think the first criteria will be that the most successful thing they can do would be something that would be simple.

And the simplest thing they could do would be something that would be ¹essentially a fuels refinery, a core plant to start with. What's the next simplest thing that they could do? Well probably produce some ²aromatics. What's

³the next simplest thing that they could do beyond that -- a few specialty chemicals. Now you're building up to the point that can they at some point develop a position in the

market such that they could competitively go up against the real big companies and force their way into the (indisc.) market. Well with some financial substance behind them, the plant in place, they've got lots -- they've got maybe a chance for doing that. What I have felt was wrong with the plan that they originally proposed was that there was no way that they could go into that market with those big companies and succeed. That those companies would keep them out and in my report I pointed out that in the chemicals business, unlike the fuels business, market share is guarded very carefully by those people who are in the market. And they really fight for market sharing on a competitive basis. And they don't really in the fuel oil business. I mean a few of them do but, you know, fundamentally EXXON and ARCO aren't out fighting for fuel oil business. If somebody wants to sell fuel oil, undercut them \$.10 a barrel, fine they'll do something else with their oil, they won't really fight them for it. But in the chemicals business, because of the high profit margin during the good times, they'll fight for their share of the market. And they fight by cutting the price. But ALPETCO is going to run against them. If they start trying to sell ethylene, they're going to run up against a situation where (a) they're unproven suppliers and where they're going to go to is being supplied to somewhere else. Now they're going to be able to woo them away from that alternate supplier either by cutting their price below the price at which their present supplier will cut price and they can't cut the price as low as their present supplier will cut price or they're going to have to (indisc.) say ALPETCO has a -- represents an assurance of future supply, which is better than their alternate supplier and furthermore that they will be willing to pay enough more for that future assured supply since there's the fact that their competitor's going to cut price more than ALPETCO can cut price, will still give them the incentive to come with ALPETCO. But ALPETCO will never be able to cut the price as low as EXXON will cut the price or as ARCO will cut the price or MONSANTO and so forth will cut the price, they just can't do it. So they've got to figure out another way to attract somebody to buy from them. And that's pretty hard to do. When somebody else will cut the price to whatever it takes to keep the business, it's hard to get away from it. And that's the fundamental problem they're going to have.

CHAIRMAN MILES:

Well I'm still unclear as to how that statement relates to what your report says. Liquids availability at the right price would likely require that the oil project be abandoned and converted to the use of NGL (ph). Either it's -- and maybe I'm just making this too black and white, but it seems to me it's going to short circuit NGL development or it's not. I don't get what the balance is or what the ratio is.

MR. MOORE:

Well I don't have a certain answer to the question either. I would say this though that if you had -- let's take ARCO, they're a big ethylene producer and they produce on the North Slope. Now if ARCO decides that it made sense to them to supply the West Coast ethylene market growth with gas liquids, I don't think that ALPETCO's -- the fact that ALPETCO is out there also, would deter them a moment. I think that they could figure that they could kick ALPETCO out of any situation that ALPETCO was in. They've got the financial muscle, the marketing muscle and everything else to do it. If it were the other way around, I think there would be a problem. I think the fundamental issue in the chemicals business is the -- not in the chemical business in general -- but the ethylene business, particularly, is that that is a very big company business. And pretty big companies have been forced out of that business because they didn't have the financial resources. And if you look at people who are in it now. It's nothing but the very largest corporations because it has gotten to require so much capital and willingness to absorb substantial downside risks under poor market conditions. It's just a game that small companies can't play.

CHAIRMAN MILES:

You're not answering my question.

MR. MOORE:

Alright, phrase it again.

CHAIRMAN MILES:

I'm trying to find out how approval of the ALPETCO contract will affect the development of gas or gas liquids in the state? Well that does seem contrary to what you said in your report.

MR. MOORE:

The report -- oh, okay I see what your problem is. If these were two separate activities (a) you had the ALPETCO contract you sign it then (b) you wanted to do something to develop the gas liquids thing. When you sign the ALPETCO contract you have not said that. What you have signed is a contract to develop a petrochemical complex. I think that is a very important understanding.

CHAIRMAN MILES:

Do you want to repeat that last one.

MR. MOORE:

Well ALPETCO has a guarantee it can build a petrochemical complex.

CHAIRMAN MILES:

I just want to make sure I heard you right.

MR. MOORE:

That's what their intention is. And that's what everybody hopes that they're able to do. But it could well turn out that the thing they -- if they put something together it may be something that does not involve a petrochemical complex initially. So that's the first point. You haven't necessarily said you're going to build a -- create a petrochemical complex by ALPETCO. And the second thing is that if you could find someone who is -- if you had a good deal on a gas liquids side, and you really were -- and you had made a policy decision that ALPETCO was the group that you were essentially cooperating with in this kind of development, then you probably would want to give them this favorable opportunity. Now if you did not choose to do that, if you said well, ALPETCO's on their own, you know, the state has no more relationship with them other than just having signed this contract guaranteeing them a supply of royalty crude and now we want to set up a -- want to entice a big chemical company to come into the state and use these gas liquids, I don't think the existence of the ALPETCO contract would deter per se would deter, you know, an ARCO or a DOW to come into here and looking at the gas liquids, if they were otherwise inclined to do so. I just don't think that the ALPETCO contract -- they would weigh it one way or the other.

CHAIRMAN MILES:

Okay. Let me put it this way then. If ALPETCO entered the contract and it's approved, does what it says it's going to do, 30,000 barrels of fuel and the rest in petrochemicals, would you recommend to a major client that they go in and develop a gas liquids facility?

MR. MOORE:

If I was sure that ALPETCO would do that?

CHAIRMAN MILES:

Yeah.

MR. MOORE:

No, I wouldn't.

MR. CHATTERTON:

Is that because the market in other words is full ^{even} enough now, saturated enough now that one plant might break in but two would be doggone (indisc.)

MR. MOORE:

And so fundamentally I'd just repeat that I think that ALPETCO -- I think it's unlikely that ALPETCO in their first realization and what their affect on the market is over the next two years or 18 months or whatever it is, I think it's unlikely that they will really be a factor in the ethylene market or the ability of a major present supplier to promote a new plant. I just don't think they'll be a factor.

MR. CHATTERTON:

If ALPETCO -- if there weren't the strings attached, why ALPETCO was trying to penetrate this market, why would they be in a much more competitive position to do so if the state's royalty share of the oil was transported to California to a petrochemical plant on the West Coast?

MR. MOORE:

Well I think the whole problem -- the point I'm trying to get across is that I see the biggest deterrent as being one that your logic in coming must be that ALPETCO -- you're going to try to keep them out of the market, regardless of their feed stocking, regardless (indisc. -- cough).

MR. CHATTERTON:

But whether it be Valdez, Kenai or the West Coast, that would be under the terms of the contract with the State of Alaska, but there is some other thing where ALPETCO could -- there is permissiveness in the contract where ALPETCO could knock anybody else out of the market.

MR. MOORE:

The contract, yeah, but not in the bank book.

MR. CHATTERTON:

But in the contract why it's permissive -- I mean presupposing they could get their feed stock at \$.50 a barrel. They could do a pretty good job, (indisc.). Even if we gave them the oil?

MR. MOORE:

Well I'd say it's in the range of feasible alternatives. I

think that it doesn't help. I don't think that they are particularly helpful one way or the other.

MR. CHATTERTON:

I see, thank you.

MR. MOORE:

We have worked with so many projects where people have tried to break into the ethylene market, people double the size of ALPETCO or even some a little bit bigger and at some point it gets down to the fact that you've got to have lots of guts or your banker's got to have lots of guts to go ahead because there's so many ways that competitors can keep you out of that market and if they're bigger than you are and they want you out of the market at some point you come to a premise that no one you've ever dealt with before has been able to -- you know, they've all backed away. And they may back away for all sorts of reasons. They can't get the financing, they can't get the contracts, so on and so forth. That's just a really rough game.

MR. PARR:

You said something about this a little while ago and I'm afraid I didn't hear you as well as I'd like to. You were talking about in the lower 48 petrochemical plants based on gas liquids hadn't been able to compete whereas this state's position versus (indisc.--loud noise) because of amortization.

MR. MOORE:

Yes, amortization of the total costs.

MR. PARR:

Yeah, and you said that they could absorb, I guess, fluctuations in price, low prices for (indisc.) I wasn't really quite -- I know so little about economics in business that I'm embarrassed but nevertheless I didn't quite understand what it was you were saying. If I understood you right, let's say this plant that ALPETCO's going to have a 2-1/2 million dollar plant, this one might be say a billion dollars, they're both selling the same product, ethylene. Now how does the fact that there's a bigger investment than the ALPETCO plant, I mean assuming that it's one of (indisc.) lower 48 situation, it wouldn't be quite as true up here. But how does that fact that one of them costs twice as much today, help them?

MR. MOORE:

Well, okay. The (indisc.) has two characteristics, one is that it produces a wider range of products and secondly is that of its total cost, only half of that cost is variable.

MR. PARR:

Their bonded indebtedness or whatever kind it is.

MR. MOORE:

The (indisc. -- simultaneous speech) cost of that plant.

MR. PARR:

That's the same year in and year out (indisc. -- simultaneous speech)

MR. MOORE:

(Indisc. -- simultaneous speech) some costs. But the cash flow that's produced by the plant only has to account for half the total cost which is the feed stocks, utilities and labor support. So if I want to cut the price if I want to compete, you know, cut the price. I can cut my price 50% and still have net dollars coming in every day from the operation of this plant. Now sure, I'm not paying the bank off as fast. Maybe I'm not paying myself back as fast on some investments. But in terms of just the sheer money coming in for the product, less the money going out for the feed stock and the utilities, I can cut prices 50% and still make a positive cash flow.

MR. PARR:

That's if your bank will let you get by with that.

MR. MOORE:

That's right. And then, of course, for that reason, you don't see anybody getting a crude oil plant -- there is no crude oil plant in the word that's not operated by an oil company.

MR. PARR:

So they have (simultaneous speech). The guy that runs the gas liquids plant though doesn't mean they are in the same position, right. There's a higher percentage of his costs are the variables, the cost of the feed stock and so forth.

MR. MOORE:

It could be over-simplifying to say whether it's good or bad. Because I could say well the crude oil plant has more products, therefore it's diversified and therefore that's good. But if you're going into a virgin market, that's bad because you've got to sell so much stuff.

MR. PARR:

So if the price of ethylene is low and the price of something else is high at this time you have a chance to sort of balance it off.

MR. MOORE:

Well if you look at the Gulf Coast where you have all the petrochemical industry there, a crude oil plant that produces all of these byproducts, there's someplace for all of those products to go because there's some plant around there that takes all of these products. Now by contrast, if you look at Saudi Arabia, something you read about in the news, they're looking at several ethylene plants but they're all ethylene plants because there's no plant anywhere around that takes anything. So their marketing problem is very complex and they'd like to just produce one product if they can, based on one product. That's a lot better than selling two products. So in all cases they're looking at the simplest plant that they can come up with so they have the simplest marketing problems; the simplest transportation problems. And this is kind of the analogy that we followed in thinking that the ethylene plant is kind of the obvious one for Alaska because you really have a virgin market. You don't have an infrastructure of other plants around you. And you have to create all that at one time; that means more money, more loose ends you have to pull together.

MR. CHATTERTON:

Well following up on that Joe, suppose we okay the contract with ALPETCO and they go ahead, and they're starting a business -- they're trying to break into the market to produce the products (indisc.) And then if somebody did decide to go into the gas liquids plant, it's going to make ALPETCO's job perhaps even harder because they've got one more competitor who can produce perhaps more cheaply than they can.

MR. MOORE:

Well I think that's true. When you're thinking in terms of ALPETCO trying to build a major petrochemical plant but under the terms of their contract, they don't have to do that.

MR. CHATTERTON:

I understand that. This is just a hypothetical case. Under their contract they have to produce 35,000 barrels of crude (indisc.)

MR. MOORE:

(Indisc.) 100,000.

MR. CHATTERTON:

Billion and a half dollars in a certain period of time or else they lose their contract.

MR. MOORE:

Yes, and that's tough. That's pretty well -- if you really stuck it with that it would tie it to --

MR. CHATTERTON:

A billion and a half is more than you can justify on just producing an amount of fuel oil and gas so they'd have to do something with it or else ...

MR. MOORE:

And personally I think ALPETCO was dumb to have agreed to that. And I think that it is not in the state's interest to hold them to that even. If ALPETCO could come up and show that they had put together a deal for 700 million dollars, 600 million dollars at the end of 18 months, they reap the contract terms and it seems to me inequity that that is a significant affair -- discharge of their obligation. And I look at it, if I were in a position of having to decide whether -- what ALPETCO had done was in conjunction with what the intent of the state was when they started out this royalty oil thing, I'd be hard pressed to say that they could spend 600 million dollars or 700 million dollars on an oil processing facility, that there was anything wrong with that.

MR. CHATTERTON:

(Indisc.)

MR. MOORE:

Well, it is, 600 million dollars is a lot of money.

MR. CHATTERTON:

Not Alaskan terms.

MR. MOORE:

In the refinery and petrochemical industry, it is. I don't

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think and I'm not positive of this, but I don't believe that it has yet been grass roots project built for a billion dollars. And you talk about it so much that you almost think it's actually been done. I don't think it's ever been done.

CHAIRMAN MILES:

What's a grass roots project?

MR. MOORE:

Oh when you start off with nothing, just build it. I go out with the grass roots and I create a plant. That's what we call a grass roots plant.

CHAIRMAN MILES:

How do they get them built?

MR. MOORE:

Well they do but there hasn't been one built that big yet.

CHAIRMAN MILES:

They're built in stages.

MR. MOORE:

Well yeah, they're built in stages and also most chemical complexes start off much smaller and so forth. You're talking about something that we've written -- seen so much of the literature about, numbers of this size. And we've almost gotten to assume that these things have really been done, but they haven't been done. Now we talked about billion dollar plants in Saudi Arabia and we talked about even -- well I look at a billion dollar and a half plant in the U. S. They've never gotten built. So we're talking -- you just get kind of hypnotised at the fact that the pipeline cost 8 billion dollars. Yeah, but look who's behind the pipeline.

CHAIRMAN MILES:

What are these 200,000 barrel a day OPEC petrochemical facilities cost?

MR. MOORE:

They haven't been built yet.

CHAIRMAN MILES:

I know, but -- I know they haven't been built yet but --

MR. MOORE:

Billion and a half, 2 billion dollars.

MR. CHATTERTON:

(Indisc.)

CHAIRMAN MILES:

Chat.

MR. CHATTERTON:

Thank you, Mr. Chairman. What's your definition of a petrochemical?

MR. MOORE:

Of a petrochemical from oil, from a hydrocarbic source?

MR. CHATTERTON:

Well if I were to build a petrochemical complex, buy a petrochemical complex and I made this a middle of the barrel fuel product slate, (indisc.) propane, a little butane, wouldn't that be a petrochemical complex?

MR. MOORE:

Well there isn't a legal definition of it.

MR. CHATTERTON:

There is no legal definition, is there?

MR. MOORE:

It's a term of art.

MR. CHATTERTON:

It's a great, broad, wide open (indisc.)

MR. MOORE:

We could probably decide in the sense of it being a term of art. But, you know, a normal person (indisc.) petrochemical complex.

UNIDENTIFIED SPEAKER:

That would make (indisc. -- laughter).

MR. CHATTERTON:

Joe, thank you, you've made a point, I hope. I don't want to admit it.

MR. MOORE:

Any other questions?

MR. PARR:

delete
Tell me one thing and this, again, is an off the top of the head answer. I've got to tell you that this one company came in and discussed with a number of us on this committee, I guess, the possibility of building a strato-plant (ph) over the gas line in Fairbanks and they buy the gas and they put it through a process (indisc.) liquids and (indisc.). It's their responsibility to market the stuff. Is it your off-hand guess that such a thing might be economically viable?

MR. MOORE:

Yeah.

MR. PARR:

Do you have much information (Indisc.).

MR. MOORE:

I think the thing that -- I think that if you just do that by itself, the thing that you probably clearly could do, you could probably recover propane, butane, (indisc.) and sell those. Now that probably wouldn't really contribute anything significant to development in the state if that were your objective.

MR. PARR:

(Indisc.) planned use.

MR. MOORE:

That people would use?

MR. PARR:

Something like the (indisc.--interrupted)

MR. MOORE:

(Indisc.) people.

MR. PARR:

It would be a real big plant.

MR. MOORE:

Oh a hundred people probably.

MR. PARR:

So in terms of an increment of employment or development it's not a real big increment.

CHAIRMAN MILES:

No, it's a term of art, (indisc.) It's a downstream manufacturer is what you'd call it -- the guy who would buy this propylene or whatever it is to make something out of it.

MR. MOORE:

Make something else out of it.

MR. PARR:

And then he came along and located (indisc. -- interrupted)

MR. MOORE:

(Indisc.)

CHAIRMAN MILES:

(Indisc.)

MR. CHATTERTON:

Joe, what's a commercial name for aromatic, one of the aromatics?

MR. MOORE:

Benzine, you mean?

MR. CHATTERTON:

Okay. Let's say the bottoms from the fuel oil refinery would contain those, would it not?

MR. MOORE:

The bottoms from the fuel oil refinery?

MR. CHATTERTON:

Well the tops -- in other words, what you didn't -- if you had products like jet fuel, diesel, stove oil and the rest shifts out why that would have -- what shifts out would have aromatics in those, wouldn't it?

MR. MOORE:

Aromatics are into gasoline (indisc.) If you make these in a plain old refinery, that made gasoline --

MR. CHATTERTON:

I'm not making gasoline.

MR. MOORE:

The aromatics of commerce appear in the gasoline business.

MR. CHATTERTON:

And if I don't take any out why they're still in there, aren't they?

MR. MOORE:

Yeah.

MR. CHATTERTON:

I've separated them from something.

MR. MOORE:

There's lots of aromatics, you know, if you try to be literal but the aromatics of commerce are primarily benzene and secondarily zylene (ph) and third (indisc. -- noise) and anything else is not really an aromatic of commerce.

MR. CHATTERTON:

And where would our olefins fit into commerce?

MR. MOORE:

If you're not thinking gasoline?

MR. CHATTERTON:

No.

MR. MOORE:

Well if you had atomic refinery, you don't have any olefins. Olefins are primarily produced in a refinery by a cracking process (indisc.)

MR. CHATTERTON:

Okay.

MR. MOORE:

Gas, oil.

MR. CHATTERTON:

Alright.

MR. MOORE:

(Indisc.) cracking bottoms or they're produced by thoroughly cracking naptha. In the petrochemical business they're primarily produced in cracking steam, so called steam cracking or steam pyrolosis (ph) a derivative material producing ethylene and propylene. So that if you had a simple refinery, you normally wouldn't have any olefins (indisc.) If you start producing olefins in a normal refinery you do it because you're making --increasing the octane of gasoline. If you're not making gasoline and you're producing olefins, you're probably producing chemicals like ethylene and propylene.

MR. CHATTERTON:

Okay. Thank you. Thank you, Mr. Chairman.

CHAIRMAN MILES:

Anything else? Joe, thank you very much. You were very, very helpful.



② He still makes no argument
for interim taking. All the reasons
for not allowing interim sales remain
pp 1, 5.

③ What about other concerns!
"commit + to spend" 7 ps

Supplementary Statement By

Earl Johnson

Before The
Senate Special Committee on Royalty Oil and Gas
State of Alaska

May 15, 1978

① "The scope of my concern and my
comments is essentially from the
standpoint of effective crude oil
marketing -- the area of my
special expertise...
Darean! + seems he knows too much
about marketing to wise his state-
ments so drastically!!!

AGO 545 697 +

Senators.

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

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

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

contract and with respect to the crude oil marketplace generally.

In arriving at some of the conclusions outlined in my earlier testimony, I had used a weighted average price FOB Valdez of \$11.45, based on the marketing of 2/3 royalty oil on the West Coast (and Valdez) and 1/3 on the Gulf Coast. These figures are essentially correct, but do not fully address the unique pricing mechanism in the proposed contract. This pricing mechanism contains a feature that substitutes the average point of delivery price of all of the other producers for the actual price of any producer whose actual point of delivery price is lower than the weighted average price of all of the other producers. This feature tends to protect the state from receiving a low price from Alpetco under any circumstance, but especially under those actual crude marketing practices now existing with respect to North Slope crude. Specifically, some 61% of North Slope Crude was marketed at Valdez and on the West Coast during March 1978, with the other 39% going to the Gulf Coast. The calculated weighted average price at TAPS inlet was \$5.16 per barrel (\$11.43 FOB Valdez). However, the pricing in the contract would set the Alpetco purchase price under the contract at \$6.09 at TAPS inlet (\$12.56 FOB Valdez). Since this would result in a delivered West Coast cost to Alpetco of approximately \$13.25, there would obviously be no incentive for Alpetco to exercise its crude option -- and certainly no way to discount in the West Coast Market

*Didn't he
read the
Contract?*

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

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

What about
their most
recent
scenario?

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

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

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

they should have negotiated the contract

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

AMENDMENT

Dated May 17, 1978

to the

AGREEMENT FOR THE SALE AND
PURCHASE OF STATE ROYALTY OIL

THIS AMENDMENT entered into as of the 17th day of May, 1978, by and between THE STATE OF ALASKA, hereinafter called the "Seller," acting by and through its Commissioner of Natural Resources, and ALASKA PETROCHEMICAL COMPANY, an Alaska corporation, hereinafter called the "Buyer," and being the Amendment to the Agreement between Seller and Buyer entered into February 22, 1978.

WITNESSETH:

WHEREAS, an Agreement for the Sale and Purchase of State Royalty Oil was duly executed on February 22, 1978, between the State of Alaska, as Seller, and Alaska Petrochemical Company, as Buyer ("Agreement"); and

WHEREAS, the Agreement may be amended under Article XXII thereof; and

WHEREAS, Seller and Buyer desire to clarify certain intentions of the Buyer and Seller therein;

NOW THEREFORE, in consideration of the representations, covenants and conditions herein contained, Seller and Buyer hereby amend the Agreement as follows:

1. Article 1.13 is hereby amended by adding the following sentence at the end of Article 1.13:

"Total Project Costs shall not include any amounts paid for the purchase of crude oil."

2. Article I is hereby further amended by the addition of Article 1.14 which reads as follows:

"1.14 The terms "committed to be expended" as used in Article 1.13 and "commit to expend" as used in Article 10.2 shall mean contractually binding agreements, contracts and purchase orders."

3. Article 2.2 is hereby amended by the addition of a sentence at the end of such Article 2.2 as follows:

"Notwithstanding any other provision of this Article 2.2 Buyer shall not be entitled to receive delivery of any royalty crude oil hereunder until (a) Buyer has actually expended at least \$100 million in Total Project Costs, and (b) at least twenty-five (25) months have passed since the Effective Date."

4. Article II is further amended by the addition of a new Article 2.7, to read as follows:

"2.7 Reduction of Quantity of Oil Deliverable to Buyer. Notwithstanding any provision of Article II requiring Seller to deliver to Buyer quantities of crude oil up to 150,000 barrels per day, in the event six years after the Effective Date the

72 mos - the time they must have expended 1.5 blm

capacity of the Petrochemical Facility is less than 150,000 barrels per day, the maximum quantities deliverable by Seller for the remaining term of this Agreement shall be reduced to that quantity equal to the capacity of the Petrochemical Facility at such time. Coincident with such reduction, the figure "150,000 barrels" appearing several places in Article 2.4 shall be reduced by a like amount. For the purposes of determining capacity under this Article 2.7, the capacity of the Petrochemical Facility shall not be diminished or reduced because of temporary reductions due to market conditions or shutdowns in the Petrochemical Facility, regardless of cause. *not operating !!!*

5. The first sentence of Article 4.2.1 is hereby amended and revised to read as follows:

"4.2.1 Construction Obligations. In consideration of the obligations assumed by each party herein, Buyer will proceed with reasonable diligence to design, construct, start up and thereafter initiate operation of a petrochemical manufacturing and fuels refining facility in the State of Alaska with capacity to process at least 150,000 barrels of crude oil per day." *What's that? need definition what does that include? (crude is going to be fuels)*

IN WITNESS WHEREOF, the Seller has caused this Agreement to be executed by its Commissioner of Natural Resources and the Buyer has caused this Agreement to be executed by its

Chairman of the Board, thereunto duly authorized by its Board of Directors in accordance with the certified seal, duly attested, to be affixed hereto, as of the day and year first above written.

ATTEST:

Frederick H. Boneas

APPROVED AS TO FORM:

Samuel H. Green

ATTEST:

Edward M. Hingst

THE STATE OF ALASKA

BY: Robert E. Lesche
Commissioner, Department
of Natural Resources
"SELLER"

ALASKA PETROCHEMICAL COMPANY

BY: O. Charles Haring
Chairman of the Board
"BUYER"

AGREEMENT FOR THE SALE AND PURCHASE

OF

STATE ROYALTY OIL

ALASKA PETROCHEMICAL COMPANY
an Alaska corporation

THE STATE OF ALASKA
Department of Natural Resources

February 22, 1978

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AGREEMENT FOR THE SALE AND
PURCHASE OF STATE ROYALTY OIL

THIS AGREEMENT entered into as of the 22nd day of February, 1978, by and between THE STATE OF ALASKA, hereinafter called the "Seller," acting by and through its Commissioner of Natural Resources pursuant to Alaska Statute 38.05.183 and ALASKA PETROCHEMICAL COMPANY, an Alaskan corporation, hereinafter called the "Buyer."

W I T N E S S E T H :

WHEREAS, it is in the mutual best interests of Seller and Buyer that Buyer construct and operate a petrochemical facility in Alaska to process the oil sold hereunder, said facility to have the capacity to process approximately 30,000 barrels per day of crude oil into energy fuels for in-state distribution and sale; and

WHEREAS, Seller has the right under each of the leases identified in Exhibit "A" to this Agreement to be delivered or paid by the Lessee thereunder a royalty of twelve and one-half percent (12-1/2%) in kind (amount) or value of the crude oil production removed or sold from the lands covered by each such lease; and

WHEREAS, the Lessees of such aforesaid leases and other parties have represented to Seller that crude oil can be recovered from such leases in significant quantities and that such Lessees intend to market such crude oil; and

WHEREAS, Seller is presently receiving royalty payments based on more than 90,000 barrels of crude oil per day from the aforesaid leases and anticipates the quantity of such royalty oil payments to increase for the next year; and

WHEREAS, Seller is authorized by Alaska Statute 38.05.183 to sell such royalty oil; and

WHEREAS, Seller desires to sell royalty oil to Buyer and Buyer desires to purchase royalty oil from Seller under the terms and upon the conditions hereinafter set forth;

NOW, THEREFORE, in consideration of the representations, covenants and conditions herein contained, Seller and Buyer hereby agree as follows:

ARTICLE I

DEFINITIONS

As used herein, the following terms shall have the following meanings:

L 1.1 "Affiliate" shall mean any person, firm, corporation or other entity affiliated with Buyer by means of a material direct or indirect ownership interest.

1.2 "Commissioner" means the Commissioner of Natural Resources of the State of Alaska.

1.3 "Date of First Delivery" means the date the first royalty oil sold hereunder passes the Point of Delivery.

1.4 "Day" means a period of twenty-four (24) consecutive hours beginning at 12:01 a.m., Alaska Standard Time.

1.5 "Effective Date" shall have the meaning defined in Article XI.

1.6 "Force Majeure" shall have the meaning defined in ^{definition} Article 15.2. _{too loose}

1.7 "Leases" or "Lease Contracts" means the oil and gas leases which are described in Exhibit "A" attached hereto and made a part hereof.

1.8 "Lessee" means any party owning a working interest in a Lease or Lease Contract.

1.9 "Month" means the period beginning at 12:01 a.m., Alaska Standard Time, on the first day of the calendar month and ending at the same time on the first day of the next succeeding calendar month.

1.10 "Oil" or "crude oil" shall have the same meaning as the word "oil" under the Prudhoe Bay Unit Agreement dated April 1, 1977, by and between the Seller and Lessees.

1.11 "Point of Delivery" shall have the meanings defined in Article III.

1.12 "Petrochemical Facility" shall have the meaning defined in Article 4.2.1.

1.13 "Total Project Costs" shall mean the aggregate of all sums and costs expended, incurred or contractually committed to be expended by Buyer, its Affiliates, direct and indirect beneficial shareholders, consultants, advisers and design, engineering and construction contractors in connection with responding to the requests

Why 1975?
They were in the
picture yet?

for proposal for the sale of royalty oil from the Leases; the preparation and execution of this Agreement; the performance of any and all obligations, transactions or events required by this Agreement; and the design, engineering and construction of the Petrochemical Facility or any portion thereof, all such costs to be measured from January 1, 1975. Total Project Costs shall also include (i) interest costs actually paid or accrued, and (ii) sums and costs expended, incurred or contractually committed to be expended by any city, borough or other governmental agency on any pollution control, sewage or water treatment, port, pipeline, terminal or other facilities, directly connected with or a part of the Petrochemical Facility, to the extent such facilities are utilized by the Petrochemical Facility. Any indirect or allocated costs shall be substantiated in writing to the satisfaction of the Commissioner.

Quoted 5/17/78 -

See Commission order NO. 1 (1.13)

ARTICLE II

See Commission order NO. 2 (1.14)

QUANTITY PURCHASED AND SOLD

2.1 Sale of Prudhoe Bay Royalty Oil. Subject to the terms and conditions hereinafter provided, and subject to the prior obligations of Seller to deliver 5,000 barrels of crude oil per day under its contract with Golden Valley Electric Association, Inc. ("Golden Valley"), for the term and in the quantity now stated therein, Seller agrees to sell to Buyer, and Buyer agrees to buy from Seller, eighty-five percent (85%) of the total amount of Seller's royalty oil out of the crude oil production removed or sold from the Leases which the Seller has the right to take, and is available to the Seller for tak-

Less 5M
100,000
offer
comp. for
Petrochemical
Plant, the
GVEA obligation
will be
satisfied
out of the
1590

ing, in kind. Seller reserves the right to use or dispose of the remaining fifteen percent (15%) in its discretion. After completion of the Petrochemical Facility, Seller's obligations to Golden Valley, if any, shall first be satisfied out of the fifteen percent (15%) portion of the oil from the Leases not being sold by Buyer hereunder. In addition to the crude oil deliverable under the other provisions of this Article 2.1, Buyer shall also possess the option to purchase an additional five percent (5%) of the total amount of Seller's royalty oil out of the Leases:

(a) in the event Seller enters into a contract with North Pole Refining Company ("NPR") granting NPR an option to purchase part or all of the fifteen percent (15%) portion of the oil out of the Leases not sold to Buyer under other provisions of this Article 2.1 and NPR does not exercise its option in full to purchase the oil on which it has an option, but Buyer's option to purchase shall extend only to the purchase of that quantity of oil from time to time not purchased by NPR; or

(b) in the event Seller does not enter into or have in effect a contract with NPR as recited in Article 2.1(a).

In the event it exercises its option under Article 2.1(a) or 2.1(b) above, Buyer agrees to give Seller an additional thirty (30) days notice of any nominations under this Article in addition to the time for notice specified in the Prudhoe Bay Unit Agreement. In the event under any agreement with NPR Seller obtains a right to purchase

5% add.
out of 15%
if NPR does
not exercise
its option
to the 15%

5% add. out
of 15% if there
is no contract with
NPR

✓ from NPR any oil returned to the Trans Alaska Pipeline System by NPR, Seller shall assign all such rights to Buyer for the term of such NPR agreement.

Seller represents to Buyer that it has obtained sufficient advance written consents to termination and an agreement from Lessees (which to Seller's knowledge has been performed) to require similar consents from all subsequent purchasers agreeing to waive or terminate any supplier-purchaser relationship as to sufficient quantities of Seller's royalty crude oil out of the Leases to enable Seller to perform its delivery obligations under this Agreement.

2.2 Initiation of First Delivery. After the date Buyer has obtained the financing commitment referred to in Article 10.2(3)(d) and has furnished satisfactory evidence of same to Seller, Buyer shall have the right, subject to the further terms of this Article 2.2, to call for the initiation of delivery of crude oil under this Agreement by notifying Seller that Buyer seeks to initiate deliveries and stating the quantity desired, which such quantity shall be not less than one thousand (1,000) barrels per day. Initiation of deliveries, therefore, may occur prior to the date the Petrochemical Facility is completed and operational. Seller, within thirty (30) days after receipt of such notice from Buyer, shall deliver notice to all Lessees that it is exercising its right to take its royalty oil in kind and stating the quantity required to be delivered. In the event Seller shall obtain a modification of the Lease Contracts or Prudhoe Bay Unit Agreement to reduce the notice period required to less than six (6) months, the Date of First Delivery under this Agreement shall be reduced accordingly, but only upon sixty (60) days' prior written

*after 1991
written
12 months
of off date
have 1.5
billion
commitment*

*What's the
signif. cause of
this?*
notice of such time reduction to Buyer. Buyer agrees, in the event
it calls for delivery of crude oil prior to the date the Petrochemical
Facility is ready to process the crude oil, that it shall fully comply
with its obligations under Article 26.6. *Supplier - Purchaser Relationship,
Termination of 10CFR, Part 211*

*Amendment
No. 3* 2.3 Certain Future Sales of Oil Taken in Kind by Seller.

From and after the Effective Date, as to any royalty oil of Seller
(other than royalty oil out of the Leases) taken in kind and proposed
to be offered for sale, other use or disposition to third parties by
Seller at a price or value which, when the reasonable costs of trans-
portation of such royalty oil to the site of the Petrochemical Facility
are added thereto, is less, on the date so offered, than the
price stipulated in Article 8.1 plus the reasonable costs of trans-
portation from the Point of Delivery to the site of the Petrochemical
Facility, equitably adjusted to reflect quality and gravity differ-
ences between the crude oil offered to be sold and the crude oil from
the Leases, Seller shall first offer to Buyer the opportunity to pur-
chase ninety percent (90%) of the royalty oil proposed to be offered.
Said oil shall be offered to Buyer at the same price, and on the same
terms and conditions, as offered to third parties. The offer to Buyer
shall remain open for sixty (60) days, after which time, if Buyer
has not accepted the offer, Seller shall be free to sell the oil under
the same terms and conditions to a third party. Seller may freely
dispose of the ten percent (10%) portion of the royalty oil not sold
to Buyer hereunder at such price and on such terms as Seller may
desire. Notwithstanding the preceding provisions of this Article
2.3, Seller may freely sell any of its royalty oil otherwise subject

*how
is
this
applied
and
who
will
do it?*

*Why is this necessary?
Since we got the value price!
And how does it tie in with the competition of the facility?*

to this Article 2.3 free of the terms of this Article 2.3 so long as any such sales and deliveries of oil at a lower price, as defined above, cease and terminate on the date the Petrochemical Facility initiates processing of crude oil; further, the provisions of this Article 2.3 shall not apply to Seller's currently pending contract for the sale of oil out of the Leases to North Pole Refining Company and except for any renewal or renewals of the current contract of Seller with Tesoro Petroleum Company ("Tesoro") for a like quantity of oil as is now being delivered under Seller's contract with Tesoro. If Buyer purchases oil pursuant to the provisions of this Article 2.3, Buyer may reduce its purchases of royalty oil from the Leases by a like amount (and shall do so to the extent its aggregate purchases of all Seller's royalty crude oil under all provisions of this Agreement exceed 150,000 barrels per day, averaged monthly) during the period it is purchasing oil pursuant to this Article 2.3. Such reductions shall be effected in accordance with the restrictions of Article 2.5 and subject to Buyer's obligation to buy and receive such oil as it has previously nominated. Oil purchased pursuant to this Article 2.3 shall be deemed oil out of the Leases for the purposes of Article 14.1(ii) only.

*What's the significance of this?
What is primarily lost?*

2.4 Buyer Option in the Event Certain Quantities Not Delivered. Upon and after the inception of operation of the Petrochemical Facility, in the event at any time and from time to time Seller has not made available for delivery to Buyer for more than two (2) consecutive months average daily quantities (averaged monthly) of royalty crude oil from the Leases equal to or in excess of 145,000 barrels per day, upon written request by Buyer, Seller shall immediately exercise any option which it as lessor may then possess, as directed by Buyer, under any other lease or leases to receive its royalty crude oil in kind rather than in value in order that Buyer has the ability to receive from Seller 150,000 barrels of oil per day, with such prior notification to the lessees under such

other leases as may be required thereunder; provided, however, that such option exercise by Seller shall only apply to seventy percent (70%) of the available royalty oil to be taken in kind and only as to such quantity of royalty crude oil as may be necessary to assure Buyer of the availability of 150,000 barrels per day in the aggregate. To protect and insure Buyer's right to receive at least 150,000 barrels of crude oil per day hereunder, after the date of execution hereof and for the full term hereof, all contracts for the sale of any royalty crude oil of Seller taken in kind (except for Seller's currently pending contract for the sale of oil out of the Leases to North Pole Refining Company and except for any renewal or renewals of the current contract of Seller with Tesoro for a like quantity of oil as is now being delivered under Seller's contract with Tesoro) shall contain a provision that Buyer shall possess a paramount right to call for and receive such royalty oil in the event deliveries to Seller from the Leases and available for sale and delivery to Buyer fall below 145,000 barrels per day pursuant to the provisions of this Article 2.4. Notwithstanding any other provisions contained in this Article 2.4, Buyer's option hereunder shall extend only to seventy percent (70%) of the royalty oil production of any field, lease, or contract in which Seller has an interest. Seller agrees that any lease agreements and agreements for the sale of royalty crude oil taken in kind hereinafter entered into will include the advance written notice of the purchaser, exchange partner or other recipient of the crude oil to the termination of any supplier-purchaser relationship which may be deemed to exist

*To the
like
and
(2)
it possible
with
the?*