

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 86 / 2

531 SCOMM16: JOINT SPEC. COMM. ROYALTY OIL & GAS 1977-78 531

1 dated December 27, I believe, 1976, and unless you're
2 like some people who may think that they're willing to
3 commit course money to build a pipeline before you have
4 a contract, I doubt if you started to do much work on
5 this problem prior to the first of the year. I'm not
6 questioning you as to the fact that in context of what
7 you were asked for and what you have presented is, you've
8 fulfilled the obligation completely, and I do concur
9 with you, with slight exceptions of your findings, that
10 this contract permits Alaska to recall and use the gas.
11 It does have that, it does provide the LPG protection,
12 but you did state here that in your proposal you would
13 not involve an analysis of the sale of natural gas
14 liquids, in your economic analysis, does provide for a
15 favorable price. Now, I think it's equally important
16 to this committee to know things that you did not find
17 in arriving at this conclusion, and obviously within
18 the framework of thirty days there's a bunch of things
19 you did not find out.

20 DR. SWANSON: There's a very large number of things of concern
21 to this committee that we did not state, that's correct.

22 REP. CHATTERTON: And possibly even the economic considerations,
23 if you had studied these things, if we had paid you more
24 money and you had had more time, it's possible -- it
25 is possible, if you had studied possibly a trade in kind

1 of gas at Prudhoe Bay with like owned State gas some-
2 place else, or State owned crude with like State owned
3 crude someplace else, or looked to see if in any way
4 this would be jeopardizing the ultimate recovery of
5 hydrocarbons from the Arctic Slope, aiding and abetting
6 the jeopardy thereof, is it possible you could have
7 come up with a slightly different conclusion?

8 DR. SWANSON: Let me list for you a number of the things
9 which perhaps are of concern which we did not study.
10 I'm not a qualified reservoir engineer. Our firm are
11 not qualified reservoir engineers. We did not study the
12 question of the level of production of natural gas
13 from Prudhoe Bay from the sedilologic sands which are
14 appropriate. On the other hand, I would assume that, given
15 the terms of the contract, that the State is well pro-
16 tected, if it were determined that to maximize the
17 recovery of oil, gas production would need to be cut
18 back, because this contract does not specify any minimum
19 quantity of natural gas which must be delivered to the
20 purchasers.

21 This contract does specify very clearly that the
22 purchasers must pay for, whether or not they can pass on
23 in their cost of service, the royalty share of facilities
24 required prior to delivery. So I'm not really sure that
25 our lack of knowledge of the specific reservoir characteristics

1 apply too much to our analysis of this contract.

2 We did not study, and I have no judgment of the
3 relative merits of the three proposed gas lines, for
4 example. A good deal of testimony has been presented
5 here, and much more before the Federal Power Commission,
6 on that issue, and perhaps you may, as individuals, in
7 your judgment, in your decisions about this contract,
8 weigh the relative merits of the three gas proposals.
9 We have not examined them, and I have no opinion, no
10 professional opinion on it.

11 We did not attempt to uncover for the State of
12 Alaska other alternate buyers of royalty gas and attempt
13 to understand from them the terms that they might be
14 prepared to offer to you for the purchase of that royalty
15 gas. I presume that in a sense the Administration, under
16 Commissioner Martin, did explore with a variety of
17 purchasers the royalty gas and possible alternate terms;
18 we did not.

19 So the question you raised, Representative
20 Chatterton, was, is it conceivable, is it remotely
21 possible that our analysis would be altered had we
22 spent more time and more effort in examining these con-
23 tracts and the alternatives which are applicable to you.
24 And when I was studying physics I read in a book that
25 it's entirely possible, it is remotely possible that

1 all of the molecules of air in this room will suddenly
2 rush over into that corner and we will all explode; I
3 think that's remote.

4 In a contract such as this, one can over-study
5 it. One should study to a point where one thinks one has
6 a grasp and can offer sound judgment to a client. If
7 we were to study, and study and study we would charge
8 for that, and perhaps not give value for money received.
9 I'm confident that our analysis is sound, our conclusions
10 are sound; I can no more say that there is no possibility
11 whatsoever of something possibly changing than I can
12 that apples will fall up instead of down. Do I answer
13 your question, sir?

14 REP. CHATTERTON: Yes, thank you very much.

15 SENATOR RADER: Senator Colletta.

16 SENATOR COLLETTA: Dr. Swanson, we have had a lot of talk
17 about the possibility and probability of what could
18 happen, and just taking the one aspect, the contract
19 provisions (period), since you deal in that area what is,
20 not the possibility but the probability of duplicating
21 a contract verbatim to what is before us now if, in fact,
22 we wait and see who builds what and when? I make
23 specific reference to one section on the total take-back
24 that we're allowed.

25 DR. SWANSON: The provisions for reserving natural gas in this

1 contract are favorable to the State. The reason that
2 the purchasers signed this contract is, as I believe
3 Mr. Tomas of Tenneco stated very clearly, that they
4 frankly don't think that either (a) you're going to take
5 back that much or (b) if you do take back that much
6 they have a good deal of confidence that Alaska will
7 experience a number of additional discoveries of gas
8 and under the terms of this contract they can buy that
9 gas.

10 Now, if you waited so long that it became more
11 probable that Alaska would take back the gas or that
12 additional discoveries would not be found and other
13 discoveries were to be committed, then perhaps you
14 couldn't get exactly the same terms with the reservation
15 clause as in this contract. I think I'm grasping at
16 something that is relatively small, and I think you may
17 well be able to get reservation clauses in the future.
18 As good as these? I don't really know.

19 The pricing provisions? I think in the future --
20 if you were to wait I think you probably will have
21 pricing provisions which are as favorable as these.
22 Whether the purchasers would pay for, at their own risk,
23 the royalty share of the costs of gathering or whatever,
24 I just simply do not know. I think likely they might;
25 I don't know.

1 SENATOR RADER: Any further questions? Any questions on
2 this side? We'll go a second round here. Senator Huber.

3 SENATOR HUBER: Thank you, Mr. Chairman. I'm sure that
4 this question was asked of other people but it was not
5 asked of Dr. Swanson, and I would like to know his answer.

6 I refer generally to the provisions in the contracts
7 that head end money, premium money, whatever you want to
8 call it, will not be allowed or will not be paid to the
9 State, but that the highest unit field prices, in the
10 language that we're both familiar with is there to state
11 that, is used. Assume now that deregulation occurs,
12 which apparently some form of deregulation is going to
13 occur, and the working interests should negotiate large
14 lump sum or front end payments with smaller amounts per
15 mcf, wouldn't our contracts then have a good chance of
16 denying the State the same opportunity for these much
17 higher prices that might be paid, or likely would be
18 paid, would be unlikely to be paid?

19 DR. SWANSON: Senator Huber, with your indulgence may I
20 characterize what I think is concerning you and then see
21 if I have characterized it correctly and then proceed
22 from there?

23 SENATOR HUBER: Please do that.

24 DR. SWANSON: Would that be an appropriate way to proceed?
25 I believe what you're suggesting is that the provisions

1 of this contract clearly state it shall be the highest
2 price specified in some other contract, and that price
3 will be in so many cents per mcf to the working interest
4 owner. You were concerned, I believe, that potentially
5 the value given in a contract or an interest owner may
6 exceed the price stated in the contract, value being
7 given to the working interest owner by an advance payment
8 on an interest free loan.

9 SENATOR HUBER: Even if it's a separate document for advance
10 payment.

11 DR. SWANSON: Or whatever, yes. I believe that is your
12 concern.

13 SENATOR HUBER: That is my concern.

14 DR. SWANSON: We have the same concern in our analysis of
15 this contract. Specifically we were aware of advance
16 payments having been made for working interest holders
17 of Alaskan gas. We then reviewed, as best we could, the
18 outstanding advance payments, the ones that had not been
19 terminated, advance payment premiums, so we uncovered,
20 particularly the Columbia Gas advance payment agreement
21 with, I guess it's BF and SOHIO. I'm not sure. And we
22 asked exactly that question in our analysis. We addressed
23 exactly that question in our analysis, would the price
24 as quoted in the contract be lower because of a previous
25 advance payment to a producer and, thus, not give full

1 value to the State.

2 Our research, looking at the contracts between
3 SOHIO and Columbia led us to believe that the advance
4 payments given to the producers would not reduce the
5 price as quoted in the contract. That was the conclusion
6 of our research.

7 Let me continue. One question that can be raised
8 is, will advance payments be allowed in the future.
9 I think the Federal Power Commission has suggested that
10 they won't be. A pipeline will give an advance payment --
11 well, the Federal Power Commission says they're not
12 doing it now -- a pipeline will give an advance payment
13 only if it can somehow recover the cost of using that
14 money or that money in its rate base. If they can't put
15 it in their rate base or they can't somehow recover it
16 from their consumers, they're unlikely to make advance
17 payment, because they can recover an allowable price.

18 Secondly, in the repayment -- I would like to say
19 something and I think I'm going beyond my current research
20 and competence and I'm not sure whether I should say it,
21 subject to verification of Mr. Moody or simply not say it.
22 I'll proceed by your judgment.

23 SENATOR HUBER: If it's part of my question I wish that you
24 would.

25 DR. SWANSON: I'll do that, but I do want to warn the two

1 committees that my recollection of the regulation of the
2 law is shaky. My recollection is that the amount of gas
3 that must be delivered for the repayment of an advance
4 payment will depend upon the subsequently negotiated
5 price for the gas. Thus, it is in the interest of the
6 working interest owner to negotiate the highest possible
7 price he can get in order to repay the advance payment
8 as soon as he can.

9 If that theory or recollection were true, and you
10 can check this with Mr. Moody, then the granting of an
11 advance payment probably would not reduce the stated
12 price in the gas sales contract and, thus, would not
13 provide full value under the most favored nations clauses
14 or the clause of deregulation in them, and in the highest
15 price clauses under this contract.

16 SENATOR HUBER: Thank you, Mr. Chairman. I feel it is a
17 little better given, the answer, from our experts rather
18 than the oil company in this case on that one. I lay
19 that one to rest as far as I'm concerned.

20 SENATOR RADER: Any further questions of Mr. Swanson?

21 Mr. Swanson, I think you were trying to catch an airplane,
22 were you, this afternoon?

23 DR. SWANSON: No, sir, I'm going to catch the 8:30 plane
24 out tonight, so I'm at your service.

25 SENATOR RADER: Would you stay for the remainder of the

1 proceedings in case questions do come up later?

2 DR. SWANSON: Yes, sir.

3 SENATOR RADER: Thank you very much. I have no particular
4 preference of order myself. Mr. Moody, Dr. Kilgore, do
5 you gentlemen have any idea as to a preference of
6 testimony, your order?

7 MR. MOODY: Whatever the will of the committee, Mr. Chairman.

8 SENATOR RADER: Why don't we take a ten-minute break and
9 let me discuss with both of you the nature of your
10 testimony and make a decision?

11 (Whereupon the hearing recessed at 2:40 p.m.
12 and reconvened at 2:50 p.m.)

13 SENATOR RADER: The committee will come to order. During recess
14 I discussed with Mr. Moody and the Doctor the order
15 of testimony, and it was the feeling that the Doctor's
16 testimony would be more in line and more relevant to
17 that which has gone immediately preceding and, therefore,
18 it would be logically easier for him to testify at this
19 time along the same lines as indicated previously by
20 Dr. Swanson.

21 Doctor, of course, you're an old hand here.
22 We all know that you're with the Levy Lipton Associates,
23 but for the record, for those who do not know you, and
24 who may come across this record, would you give us a
25 full statement of your firm and yourself, and then proceed

1 with the statement, which I presume then we would open
2 to questions.
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1 MR. KILGORE: All right, thank you, Senator. My name is
2 Richard Kilgore. I'm Director of Research for W. J.
3 Levy Consultants Corporation. Our firm has been economic
4 advisor on matters of oil and gas to the Legislature since,
5 I believe, 1969. We are also consultants to a number of
6 oil companies, domestic and foreign, small and large.
7 We also are consultants to a number of chemical companies
8 on feed stock procurement and feed stock availability
9 and so on. We're also consultants to a number of major
10 oil users such as electric utilities, mining companies
11 and the like. In addition to the State of Alaska, we
12 are consultants to a number of other governments, at the
13 present time the Province of Alberta, for example, and
14 Pertamina, the state oil company of Indonesia, among
15 others.

16 As for myself, I'm an economist by training, a
17 Bachelors Degree in Economics from Rutgers University,
18 and a Masters Degree from Carnegie Mellon University.
19 Senator, you've been calling me Doctor; that is incorrect.
20 I'm one of those who passed Ph.D. exams and never wrote
21 a thesis, so I would like to correct that.

22 I've been with W. J. Levy since 1963, just about
23 fourteen years now. Prior to that I spent two years with
24 the National Bureau of Economic Research, which is a major
25 non-profit research organization. I was also with the

1 Econometric Institute for a short while, and also did
2 some work for the Committee for Economic Development.

3 I would like to make what I hope are relatively
4 brief opening remarks, and they really have to do with
5 how we, as your economic advisors, view what you're trying
6 to achieve through these contracts. At least my opening
7 remarks today are addressed primarily to the underlying
8 reasons for sale of Prudhoe Bay royalty gas.

9 I'm going to cover such things as what are the
10 interests of the State of Alaska, what issues can Alaska
11 properly decide for itself; set against these, what
12 are the broader national interests; and how do Alaska's
13 interests fit into the national decision making process
14 on this gas pipeline. And we'll try to put these in
15 the context of the contracts before you.

16 As I said, my initial remarks will have relatively
17 little to say about the contracts themselves. As an
18 opening statement, our view can be characterized this
19 way: if Alaska decides that sale of royalty gas is
20 essential to support of an all Alaska pipeline route,
21 we feel that the contracts, in general, are carefully
22 conceived to protect the State's interests.

23 The primary objective in entering into agreements
24 for sale of Prudhoe Bay royalty gas at this time is to
25 provide support for an all Alaska route. We would like

1 to review briefly the reasons for Alaska's interest in
2 that route and the importance of these reasons. As we
3 see it, there are basically two types of benefits to the
4 State in an all Alaska route. First, there appear to be
5 certain fairly clear-cut economic benefits, although
6 probably offset to some extent by some social costs.

7 And second, there is the question of the potential
8 availability of gas for State use with the El Paso route.

9 We would like to provide some perspectives on
10 both of these potential advantages. Among the pipeline
11 alternatives there are certain economic advantages to
12 the State that can be reasonably established. These
13 were reviewed by the Governor's Task Force, and then the
14 report, Comparative Evaluation of Prudhoe Bay Natural
15 Gas Pipeline Systems.

16 An all Alaska route, together with its liquefac-
17 tion facility, does appear to provide the greatest economic
18 advantages in certain key areas. Employment is an
19 obvious one; resulting income flows to Alaska's labor
20 force, although all these will obviously not be State
21 residents, there will be migrants too. Employment and
22 income should be higher, both in the construction and
23 operating phases of the El Paso facility, as against
24 others. The greater length of the line, and the LNG
25 facility virtually insure this will be the case.

1 Tax revenues to the State treasury should also be
2 higher, largely through the operation of your property
3 tax. Again, it's the greater length of the line and
4 the LNG facility that make this possible for you.

5 Now, another major source of State revenue from
6 Prudhoe Bay natural gas will be royalties and severance
7 tax, both of which are based on wellhead values, as you
8 know. The Governor's Task Force concluded that these
9 revenues would not be affected by alternative routings;
10 that is, that higher or lower transport costs to markets
11 would not bear on wellhead values.

12 Now, we agree that as long as sales of Alaskan
13 gas in interstate markets continue to be regulated by
14 the Federal Power Commission, this is likely to be the
15 case; that is, that wellhead values will probably be
16 established on a basis other than a net-back from markets,
17 that transportation would probably be added on to a
18 regulated wellhead price, and the final price would be
19 rolled into the final cost of gas to distribution
20 companies and to ultimate consumers.

21 The FPC staff, I believe, has recommended the
22 rolling in of high-cost gas supplies such as foreign
23 LNG and Alaskan Arctic gas, and I understand that Judge
24 Litt has also recommended this approach for high cost
25 sources.

1 Under deregulation this is not necessarily the
2 case, that the costs of transportation would not bear
3 on prices. Transport costs, in that case, would have
4 an ultimate bearing probably on the value of Prudhoe
5 Bay resources. But we basically feel that deregulation
6 is not a too likely event for some years to come.

7 We would caution, however, that Alaska cannot
8 always assume that the value of its resources will be
9 unaffected by the routing of its exports. In the long-run
10 this may be the case. I think Prudhoe Bay provides a
11 current example of some of the problems of transportation
12 costs on wellhead value. As you know, there is a problem
13 of potential crude surpluses on the West Coast, the major
14 market to which Prudhoe Bay crude will move. And there
15 is a possibility that some volumes of Alaskan crude may
16 have to move to quite distant markets, that is, beyond
17 the West Coast, around to the Gulf and East Coast of the
18 United States, and this would be at very high tanker
19 transportation costs since the oil must move in U.S. flag
20 vessels and the distances are very substantial.

21 And if this is the case, if Alaskan crude does
22 move in this direction in any kind of substantial volumes,
23 there will inevitably be a question of the value of Alaskan
24 crude in Alaska; that is, what market is its value
25 established in. We feel that over the long-run it is not

1 in the national interest, and probably not in Alaska's
2 interests either if its wellhead values are affected,
3 to funnel ever larger and larger volumes of Alaskan
4 energy supplies through California; that is, larger and
5 larger volumes beyond Alyeska crude and beyond the El Paso
6 route, if that is chosen.

7 If major oil reserves are found in Petroleum
8 Reserve No. 4 on the North Slope, for example, a strong
9 case will be made for a pipeline to move that oil through
10 Canada I think, despite the fact that you have a
11 pipeline corridor southward. Incidentally, if the gas
12 Arctic pipeline is not built and an oil line moves in
13 that direction, it would then be pioneering a corridor
14 rather than following a corridor which might be established
15 had the gas Arctic pipeline been constructed.

16 But this is somewhat aside. We believe it is
17 reasonable to assume that the value of Prudhoe Bay gas
18 will most likely be unaffected by the cost of alternative
19 pipeline routes, at least for many years ahead. And
20 let me also say that we've looked at the various studies
21 that have been made on the costs of transportation,
22 what the FPC has done, what other people have done, and
23 we are not entirely certain in our own minds which system
24 would, in fact, have the highest cost of transportation.
25 It looks like a very uncertain thing to us. A lot of the

1 cost estimates are based on probabilities of delays,
2 cost over-runs and so forth, that are very, very difficult
3 to assess, in our view.

4 Against positive advantages in terms of employ-
5 ment, income and tax revenues, there are other factors
6 to be considered as well by the State; and, as the
7 Governor's Task Force concluded, some of these may be
8 negative to the State in an all Alaska routing if one
9 looks at such things as social impacts, the effect on
10 the cost of living, prices in Alaska, and so on, and
11 also looking at environmental factors which are, obviously,
12 very difficult to assess. The all Alaska route also
13 involves an LNG facility, movement of LNG tankers out of
14 Alaska, and these pose new environmental concerns, and
15 ones we feel are very, very difficult to assess.

16 However, these are all factors that the State and
17 its citizens must evaluate and weigh with the more clear-
18 cut economic advantages from taxes, employment and so
19 on. Your own Task Force concluded that the positive
20 advantages outweighed the negatives, as you know.

21 The second reason for supporting an all Alaska
22 route is the potential availability of natural gas for
23 in-state use, and it is very clear -- I've been through
24 all the -- I've sat also through all the hearings -- it
25 is very clear from your questions that many of you

1 consider that aspect very vital.

2 It is obvious that the potential availability of
3 gas is quite different among the three pipeline alterna-
4 tives. El Paso moves to tidewater, and this could be
5 very important for uses of gas in industries which involve
6 export of their products to Lower 48 markets, obviously;
7 being on the water, near water transportation, is
8 important.

9 Alcan, of course, moves gas to Fairbanks and
10 then moves off in a southeasterly direction, and in
11 directions which run through areas that are, obviously,
12 not very populated.

13 Gas Arctic route, of course, provides gas
14 essentially just on the North Slope.

15 It is difficult, however, to assess how much value
16 to be placed on this greater potential availability of
17 gas for in-state use. We should point out first that
18 there may well be other gas available in the State over
19 the years ahead. Exploration is beginning now in other
20 areas, the Gulf of Alaska, Lower Cook Inlet, Bristol
21 Bay and so on. Gas may be discovered in one or more
22 of those areas, and it is possible also that gas may
23 be available for in-state uses from these areas at
24 lower costs, lower transport costs and the like.

25 As an aside, I think we should also mention

1 something that we have before, that to the extent that
2 the State of Alaska feels that in-state use of gas is
3 very important to it or may be important to it in the
4 future, they might consider in their leasing policy,
5 perhaps changing leases so that what they have available
6 to them, to the State, is not simply a royalty which
7 can be taken either in value in kind. Perhaps the State
8 should consider some sorts of options in leases which
9 provides the State's future ability to buy back gas if
10 the State feels that's necessary. This is not what is
11 under your consideration now, but I think I should say
12 again one should consider this if use of gas, you feel,
13 is important in your State.

14 In any event, all may not be lost in terms of
15 future availability of gas if the Gas Arctic route is
16 chosen. As for now, however, it is Prudhoe Bay gas
17 that is becoming available, and other potential supplies
18 are obviously very speculative. And El Paso clearly
19 has the potential to make more gas available to more
20 locations in the State of Alaska. But what then really
21 are the advantages in using gas within the State of
22 Alaska?

23 You have major oil resources in the state, as you
24 all know, and you're obviously not an energy short region.
25 I believe we've pointed this out before, but we would

1 like to again: there is likely to be an economic advantage
2 to using gas versus oil in an area such as Alaska, which
3 is a major exporter of energy and also an exporter which
4 is remote from its major markets. The reasons for this
5 is that the economics of transportation clearly favor
6 movement of oil over gas.

7 Gas transport costs per btu are roughly three to
8 four times that for oil when the gas is moving overland
9 by pipeline. Gas transport costs are roughly ten to
10 fifteen times higher when the gas is transported over
11 water as against transportation of crude oil over water.
12 Thus gas, which carries very high transport costs,
13 tends to have a lower value in an area such as Alaska,
14 an exporting area such as Alaska; and oil, a higher value.

15 In general then, the economics tend to favor
16 use of gas in Alaska and export of oil. To put it another
17 way, gas is a better btu bargain locally, oil a better
18 product to sell nationally. But we want to caution you
19 and point out that gas transportation within Alaska is
20 also, obviously, expensive if distances are very great
21 over which gas must move; it's possible that the general
22 economic advantage of using gas internally could be
23 wiped out. But in general, the distances that you're
24 likely to move gas to markets are likely to be compara-
25 tively short, at least as compared with the distances

1 you would be moving it to export markets in the Lower 48.
2 Thus, in general, we would expect that gas will be a
3 relatively attractive fuel for use in the State, as
4 against oil.

5 While there can be significant cost advantages
6 to using gas in Alaska, the potential volumes that might
7 actually be consumed, we believe, are very elusive.
8 We've looked at a number of studie that have been done
9 projecting these volumes, and we think it is by no
10 means certain that the volumes would be very large,
11 especially any time in the near future.

12 It is even difficult to estimate what future
13 residential, commercial and conventional industrial
14 fuel uses might be in Alaska. Realistically, as I said,
15 we believe that the volumes are not likely to be very,
16 very large. We would note that in the Anchorage area
17 where gas has been available for many years, as you know,
18 and which is the area's most populous region, Alaskan
19 consumers are now consuming something like two hundred
20 million cubic feet a day of natural gas. Your royalty
21 share of Prudhoe Bay gas might be on the order of three
22 hundred million cubic feet a day, or about fifty percent
23 more than is currently being consumed in Anchorage,
24 where it has been available for many years, and where
25 a large part of your population lives.

1 Now, new industries are possible. Copper, iron
2 ore, nickel were pointed out by the Governor's Task
3 Force, but they also were very candid in admitting
4 that, and I quote, "At the present time there have been
5 no large-scale, serious and detailed proposals by the
6 private sector to utilize Prudhoe Bay gas for in-state
7 use."

8 Non-conventional uses of gas, and we've heard
9 some testimony about these, such things as using gas
10 as a feed stock for petrochemicals or for methanol are
11 even more uncertain, we believe. If these do materialize
12 it seems likely that it would be many years down the road.
13 While the resources are available in Alaska for these
14 types of operations, the economics of scale and of
15 transport of products to other areas tend not to favor
16 Alaska and tend to work against the economics of
17 these industries in Alaska. We don't mean to say
18 nothing of this sort will ever come about, but what we
19 are saying is that one has to look very carefully at
20 the economics of these things, and it is uncertain,
21 quite uncertain as to what volumes would be used in
22 the foreseeable future for these unconventional uses.

23 So, as we see it, the State's interest in an
24 all Alaska route depends on, first, reasonably clear-cut
25 net economic and social benefits; second, the potential

1 availability of gas for in-state use which, in principle,
2 could provide economic advantages as against other fuels,
3 notably oil. But the volumes that might be used, and
4 their importance, is very difficult to judge and
5 uncertain.

6 But it is up to the State and its people to
7 decide how important these factors are to their interests,
8 and how vigorously, and by what means it wishes to
9 pursue these interests. We do not, however, feel that
10 the State of Alaska can really be the judge of what
11 pipeline route is in the best overall national interests.
12 There are a great many factors that bear on this beyond
13 the interests of the State. Alaskans should be aware
14 that other routes than an all Alaska route might have
15 greater overall advantages to the Nation.

16 On the other hand, if Alaska feels strongly
17 about what it sees are important advantages to the
18 State in the all Alaska route, what is important is
19 that these interests are considered and weighed in the
20 national decision making process that is now taking
21 place as to the routing of the pipeline.

22 We were struck, in reading the FPC staff report,
23 which strongly recommended the Gas Arctic route, that the
24 interests of Alaska and potential benefits to the State
25 were apparently not really considered at all. Judge Litt,

1 in his decision, and I haven't read it all, I haven't
2 read it in its entirety, acknowledges that -- and again
3 I quote, "Alaska's views are entitled to substantial
4 weight." However, I suspect that he is not as convinced
5 of the validity of Alaska's arguments and gives them
6 less weight than most Alaskans might wish.

7 If Alaska feels strongly about what it believes
8 are the interests of the State in an all Alaska gas
9 pipeline, it will want to work to insure that its views
10 get a very careful hearing in the nation's decision-
11 making process. The sale of Alaska's state royalty gas
12 is one way of attempting to do this. If this approach
13 is chosen, we believe that the contracts before you are,
14 in general, as I said before, carefully conceived and
15 effective in protecting the State's interests.

16 We are not legal advisors to the State, I want
17 to caution, and we have no legal expertise, and there
18 are others here who do. But I would like to make the
19 following general comments on the contracts.

20 Some questions have been raised about the pricing
21 provisions, and you will obviously have to consider
22 these very carefully. You obviously are by the nature
23 of your questions. In the end, it seems to me, you will
24 have to assess the likelihood of these contingencies that
25 are spoken about; that is, the likelihood that the State

1 might be able to get a higher price if it didn't sign
2 this contract. Various alternatives have been thrown
3 out. Some of them seem to involve sales of emergency
4 gas to industrial users, questions of whether the State
5 would be caught on a vintaging problem if it signed
6 the contract now, and get a lower price, and so on.
7 From your questions it's obvious also that you are taking
8 the approach that we would recommend, trying to assess
9 what the possibilities of these things happening are.
10 I'm sure you're going to ask me more questions on this.

11 In general, I've looked at these possibilities;
12 I think they're relatively unlikely. And second, if you
13 conclude that these things are possible, that is that it's
14 possible that the State might get a lower price by
15 entering this contract, and even if you assume that that
16 possibility is very small, you might want to consider
17 how could one protect oneself against this possibility.
18 You'll have to ask yourself, could you write contract
19 terms or modify this contract in a way which would pro-
20 tect you from these eventualities. Well, I don't know
21 whether I have the answer to this, but I suspect it's
22 probably doubtful that you could. I think there are
23 probably other witnesses who may be able to give you a
24 better answer to that.

25 Now, as to the other provisions, the recall

1 provisions seem to us to be very strong. It is difficult
2 for us to see how they really could be improved upon
3 very significantly.

4 We are also pleased with the State's ability
5 to get access to liquids under the contract. We have
6 always felt that liquids could be very important to the
7 State, if not as a petrochemical, or a feed stock, or
8 for methanol, or something rather exotic, we think that
9 they could be especially of value as a fuel to local
10 residents, especially to businesses and residents in
11 remote areas. So that we feel that liquids, in the end,
12 could perhaps be of even more benefit to the State for
13 in-state use than gas itself. It's a possibility, and
14 we're very pleased with the provisions of the contract
15 in that respect.

16 In sum, the Legislature will have to consider
17 carefully what its interests are and how to pursue those
18 interests. In the end, only you can decide whether the
19 contracts before you are an effective mechanism for
20 achieving your objectives. Thank you.

21 SENATOR RADER: Thank you, Mr. Kilgore. Any questions?

22 Mr. Gruening.

23 REP. GRUENING: Mr. Kilgore, when you mentioned studies that
24 you looked at for in-state use of royalty gas, which
25 studies were they?

1 MR. KILGORE: Well, there was one prepared by your Division
2 of Natural Resources.

3 REP. GRUENING: Could you identify it specifically?

4 MR. KILGORE: I think I have it with me. "Analysis of
5 Prudhoe Bay Royalty Natural Gas Demand & The Proposed
6 Prudhoe Bay Royalty Natural Gas Sale" dated January 1977.
7 It's a study done by the State of Alaska, Department of
8 Natural Resources, Division of Minerals and Energy
9 Management.

10 Now, I don't want my remarks to be construed
11 to mean I quarrel with this study. It's very difficult,
12 all I'm saying -- estimating future requirements is an
13 extremely difficult and uncertain thing, and this may be
14 as good a job as can be done, but the results are still
15 highly uncertain.

16 REP. GRUENING: Did you do an analysis of what projected
17 uses might be?

18 MR. KILGORE: No, we have not.

19 REP. GRUENING: In that regard, the testimony yesterday
20 from Mr. Thomas Stahr was that the Anchorage utility
21 saw that in 1985 their needs in Cook Inlet would be
22 exhausted. In your readings or studies have you
23 established that to be true?

24 MR. KILGORE: No, I really don't know whether that is true.
25 I do not know how much gas is committed to that pipeline.

1 REP. GRUENING: But the major part of that would be that
2 two hundred million cubic feet per day that you referred
3 to that's used there?

4 MR. KILGORE: Yes, a significant part of that does go for
5 generating electricity in the Anchorage area.

6 REP. GRUENING: And the total royalty share at peak capacity
7 is about two hundred-fifty to three hundred million
8 cubic feet per day?

9 MR. KILGORE: I said very roughly three hundred million cubic
10 feet a day. That's an eighth of 2.4 million cubic feet
11 a day, a very rough number.

12 REP. GRUENING: Did you run across a date at which at least
13 the present known reserves at Cook Inlet are exhausted?

14 MR. KILGORE: No, I haven't. The gas reserves data are
15 available. The American Gas Association has estimates
16 of reserves in the area.

17 REP. GRUENING: Do you recall whether that study of January
18 '77 covers that point?

19 MR. KILGORE: No, I don't recall. As I recall, it was
20 basically an analysis of potential gas demands along the
21 route of the pipeline.

22 REP. GRUENING: But it didn't take in total the gas demand
23 in the State?

24 MR. KILGORE: I believe not.

25 REP. GRUENING: Are you familiar with the provision that

1 allows the companies that are purchasing to take one and
2 a half times new reserves that are discovered to replace
3 gas that we call back?

4 MR. KILGORE: Yes.

5 REP. GRUENING: Do you see any economic disadvantage to the
6 State in doing that? It was raised, I think by Mr.
7 Dallas, yesterday . He pointed out that, say, reserves
8 were found in Cook Inlet, new reserves or, say, Copper
9 River Basin, that we would be giving them lower priced
10 gas. In other words, because of the lower transportation
11 costs we would be giving them gas at a lower price than
12 we should.

13 MR. KILGORE: Well, frankly, I don't know the answer to that.
14 As I originally read the contract I thought it referred
15 to gas which traversed the whole length of the pipeline,
16 that this was gas they would have a call on. I was
17 thinking in terms of North Slope new discoveries or
18 more gas on the North Slope. I really don't know the
19 answer to that question.

20 SENATOR RADER: Representative Parr.

21 REP. PARR: Mr. Kilgore, you mentioned a while ago that one
22 of the possibilities was gas from OCS, you mentioned the
23 Gulf of Alaska, etc.

24 MR. KILGORE: Yes.

25 REP. PARR: And that this might be cheaper than what we could

1 get from the North Slope actually. As you know, of
2 course, the Supreme Court has held that all belongs to
3 the Federal Government and we don't have a claim on it.
4 So I suppose we would have to buy it from the producers.
5 Even considering the fact that we would be buying it
6 rather than using our own royalty gas, do you think the
7 economics are still such that we would do better by
8 taking OCS gas, assuming it is produced in reasonable
9 quantities?

10 MR. KILGORE: I think the answer to that is very uncertain.
11 It's impossible to really know. One doesn't know the
12 pricing of this gas, one doesn't know the physical cir-
13 cumstances under which it would be produced, what sort
14 of costs would be involved in bringing it to shore and
15 so on. I think the answer is, one cannot really determine
16 in advance whether that gas would be cheaper. It could be.

17 REP. PARR: Is it also possible, Mr. Kilgore, that the Federal
18 Power Commission could decide where the OCS gas would go,
19 it might say it would all go to Pennsylvania rather than
20 staying in Alaska at all?

21 MR. KILGORE: Yes.

22 REP. PARR: Thank you, Mr. Kilgore.

23 MR. KIGORE: Certainly.

24 REP. PARR: Two different points. You said a while ago
25 it didn't seem really that there was too good a potential

1 at least at the present for use in the State of the gas.
2 At least it seemed to be highly doubtful as far as you
3 were concerned.

4 MR. KILGORE: What I said was, it's very uncertain, it's
5 elusive, and we suspect that the volumes would not be too
6 large.

7 REP. PARR: Does that mean what you're saying is that you
8 don't anticipate, at least in the foreseeable future,
9 a sufficient demand; is that what you're saying; or are
10 you simply saying you can't tell? I'm not sure.

11 MR. KILGORE: What we're saying, it's very difficult to tell.
12 If you want a judgment, I suspect it's lower volumes
13 rather than higher volumes.

14 REP. PARR: Has your company ever done any kind of a study
15 as to the lowest economic threshold at which petrochemical
16 plants and so forth will become feasible, of the kind
17 that might be built, let's say, in Alaska using the
18 royalty gas?

19 MR. KILGORE: No, we have not made formal studies of that.
20 We know some of the problems of the economics involved
21 and so forth, but we have not done a formal -- this is
22 from broad knowledge chemicals and so on. It is not from
23 a detailed study of the potentials for petrochemical
24 uses in Alaska.

25 REP. PARR: Could we assume that the use of natural gas in

1 other communities in Alaska would be roughly comparable
2 to that being used in Anchorage? I'm not talking absolute
3 terms, of course, but in, say, relationship to the
4 population? Fairbanks, for example, is roughly --
5 the Fairbanks immediate area is roughly one-third the
6 size of Anchorage. Now, do we anticipate that they
7 would use about one-third as much as Anchorage, or does
8 that vary quite a bit?

9 MR. KILGORE: I think, if one has to make a guess, you might
10 guess that it might be lower per capita. Don't forget,
11 Anchorage is a populated area, you have a density of
12 population, and this provides advantages, economics of
13 scale of putting in distribution systems and things of
14 this sort. If you were going to put gas into Fairbanks
15 there would be a very, very high expense of putting in
16 a distribution system. If you look at other more remote
17 areas, the economics of just getting it there and the
18 scale of population, or the users in those areas, is
19 quite small and tends to work against the advantage of
20 gas use.

21 REP. PARR: That was going to be my next question. You did
22 say, I believe, something about the possibility of using,
23 I believe, butane and propane, which are the liquids
24 from the natural gas, especially for remote areas.
25 One thing you really didn't touch on very much was the

1 liquids. You said you thought it was desirable to the
2 State to have them. Do you have any idea of the economic
3 feasibility of taking liquids out in the State, let's
4 say propane and butane, and shipping those to remote
5 areas of the State to use?

6 MR. KILGORE: Some liquids, obviously, have to come out,
7 I guess there's been testimony here. On the North Slope
8 there will be some taken out for pipeline reasons. The
9 answer is no, we have not done detailed studies on the
10 economics of the use of propane as a fuel in areas.
11 The statements I made really come from our broad judgment
12 and from our knowledge of the industry, not from detailed
13 studies.

14 REP. PARR: Thank you, sir.

15 SENATOR RADER: Representative Hayes.

16 REP. HAYES: Mr. Kilgore, yesterday Mr. Thompson of the
17 Alcan Pipeline testified that in his opinion one of the
18 advantages of the Alcan route over the El Paso route
19 was an approximately Eight Hundred Million Dollars of
20 additional revenue to the State. From your testimony
21 I conclude that you don't agree with this, and if my
22 conclusion is correct is that because you don't agree
23 with their projected construction costs or you don't
24 agree with his statement that if construction cost is
25 less it will result in a better price to wellhead?

1 MR. KILGORE: It's the latter. I don't quarrel with his
2 or anybody else's construction costs because I don't
3 have my own estimates. What I'm saying, we really don't
4 know what the circumstances of pricing of Prudhoe Bay
5 gas are going to be. If it's still regulated by the
6 Federal Power Commission we don't know quite how they're
7 going to regulate it. We don't know whether there will
8 be regulation and so on.

9 We think the most likely thing is that we will
10 have continued wellhead gas regulation by the Federal
11 Power Commission and that it will set prices independently
12 of what the transportation costs are. That's the most
13 likely thing to happen.

14 If you're looking down the road and we really
15 have deregulation, then the cost of transportation could
16 have an impact on the value of gas at Prudhoe Bay.

17 REP. HAYES: If I might continue on that, we have had
18 testimony here that we can expect deregulation of some
19 sort down the line. Would you agree with that?

20 MR. KILGORE: Well, if far down the line is a very long
21 period of time, yes, I think you can't rule it out.
22 We think it unlikely it would come anywhere in the near
23 term.

24 REP. HAYES: Anytime during the life of the contract?

25 MR. KILGORE: The life of the contract is?

1 REP. HAYES: Twenty years.

2 MR. KILGORE: Twenty years. Well, near the end of the contract
3 I suppose the probabilities get higher.

4 REP. HAYES: But in any event, in your opinion, you don't
5 anticipate any regulation that would be beneficial to
6 the wellhead price in the next ten years.

7 MR. KILGORE: I think that's most likely, there will not be.

8 SENATOR RADER: Senator Sumner.

9 SENATOR SUMNER: My concerns lie primarily in the area, say,
10 of economic development potential, whichever line is
11 chosen. Which line, in your view, would provide more
12 economic development opportunities for the State of
13 Alaska?

14 MR. KILGORE: Well, I think the all Alaska; I think that's
15 reasonably clear.

16 SENATOR SUMNER: Do you think that petrochemical manufacturing
17 is a potentially viable interest for our future?

18 MR. KILGORE: I think it may be. I don't know at the present.
19 I think it might be and I think obviously this is something
20 you want to look at. You will want to get people,
21 chemical companies who do this kind of thing to look
22 at it very, very carefully for you. I don't want to
23 imply, anything that I've said, that you shouldn't pursue
24 economic development.

25 SENATOR SUMNER: There seemed to be some doubt in your mind

1 as to whether it might not be feasible, and yet the
2 primary interest in using the Alcan line, or the all
3 Alaska line, would be for that primary benefit. Yet
4 you seem to have a fair amount of hesitancy as to
5 whether that's ---

6 MR. KILGORE: I think this is something that you're obviously
7 interested in. I guess, yes -- what I'm really saying
8 is I wouldn't overdo my expectations as to what you will
9 get because you have gas available.

10 SENATOR SUMNER: If we don't get the all Alaska line what
11 opportunity in the future do you see where there might
12 be a possibility of getting gas to tidewater or an Alaska
13 line bringing the gas down?

14 MR. KILGORE: Is your question where else one might get gas?

15 SENATOR SUMNER: What is the opportunity of getting gas to
16 tidewater in the future if we don't get the Alaska line
17 that's proposed?

18 MR. KILGORE: That depends on what the chances are of finding
19 gas in the area close to tidewater, and there are a number
20 of prospective areas where gas could be found. But
21 there isn't anyone, including myself, I'm not a geologist,
22 but one who really knows geology, who can tell you for sure
23 exactly what the probabilities are of finding gas in
24 these areas because there has been, as you know, virtually
25 no exploratory work in many of these areas. So you just

1 can't assess in advance how much you might get or what
2 the chances are.

3 SENATOR SUMNER: Are you aware of any interest at the moment
4 from different chemical companies that might have an
5 interest in Alaska in the petrochemical area?

6 MR. KILGORE: No specific knowledge. In the past -- as I
7 say, we have some chemical company clients -- we have
8 very broadly suggested they might want to look into this
9 possibility. But I don't know of any detailed proposals
10 of looks at the present time.

11 SENATOR SUMNER: And if I've drawn the right conclusions,
12 you're saying that the Arctic line provides virtually
13 no economic benefit or development benefit for the
14 State of Alaska except money; the all Alaska line provides
15 the most opportunity of the three lines; is that correct?

16 MR. KILGORE: In terms of economic advantage and potential
17 availability of gas.

18 SENATOR SUMNER: Thank you very much.

19 SENATOR RADER: Senator Butrovich.

20 SENATOR BUTROVICH: Mr. Kilgore, in your work for the State,
21 have you people projected changes in population down
22 the road?

23 MR. KILGORE: No, we have not, Senator. We have not been
24 asked to do that.

25 SENATOR BUTROVICH: Are you aware of what is happening in the

1 way of population in Alaska?

2 MR. KILGORE: I know that it's growing rapidly, yes.

3 SENATOR BUTROVICH: Can you see any difference in shipping
4 a product by water, say, from an Alaska port to the
5 South 48 than from Alaska to Japan or from South America
6 to the United States?

7 MR. KILGORE: Well, obviously the costs of transportation
8 depend upon the distances involved, but in the case of
9 Alaskan shipments to the Lower 48, they also involve
10 the use of U.S. flag vessels, which are considerably
11 higher on cost than foreign flag vessels. Shipments
12 from Alaska, for example, to Japan would not have to
13 move in U. S. Flag vessels.

14 SENATOR BUTROVICH: You are aware, however, I assume, or are
15 you aware that when the consumer in Alaska buys something
16 he is generally paying the freight up and the freight
17 back because of the fact that there is no back haul?

18 MR. KILGORE: Yes, sir.

19 SENATOR BUTROVICH: Wouldn't you consider the possibility
20 of a petrochemical industry in Alaska greatly reducing
21 that span of cost to the people living up here if,
22 indeed, there was a back haul?

23 MR. KILGORE: Yes. I think it's obviously something you have
24 to look at. It's an important objective for you to
25 pursue. You see a problem and you obviously should

1 pursue it. The problem may be that -- I said may be --
2 certain types of chemical processing, you're talking
3 about a plant on a very large scale, and a very small
4 part of the output of that plant may be consumed locally
5 in Alaska, which means that a very large part of the
6 output may have to go to other markets, and you have to
7 look very carefully at how competitive that big part
8 that goes elsewhere is with supplies from other sources.
9 I don't want to prejudge the answer.

10 SENATOR BUTKOVICH: No, I'm sure you don't. It's awfully
11 hard for me to reconcile, in this day and age, why it
12 is not as practical to ship by water from Alaska as it
13 is to ship by water anywhere else. There's no such
14 thing anymore anywhere that I know of where such a thing
15 as cheap labor exists. That used to be a great argument,
16 but it certainly doesn't exist in the United States today.
17 I, for one, don't think that enough emphasis and enough
18 study has been developed on the petrochemical side of
19 this question.

20 MR. KILGORE: I would agree with that.

21 SENATOR RADER: Senator Huber.

22 SENATOR HUBER: Mr. Chairman, I do have a couple. Dick,
23 do you believe that the contracts that we have before
24 us are attractive enough to disregard the earlier
25 admonitions of Walter Levy and Milt Lipton to be very

1 cautious about committing our future oil and gas supplies
2 before delivery systems actually exist that are able
3 to transport them? We've heard that many times from
4 Milt and Walter, and can you expound on it?

5 MR. KILGORE: I think, as a general proposition, I would
6 probably agree with that, but what one has to do is --
7 here you have a new objective, something else which you
8 are trying to do with these contracts. You obviously
9 have a purpose for doing it; it's to help promote a
10 line which you seem to be quite interested in having,
11 and you just have to assess that against a more general
12 position that perhaps waiting is better. You really
13 have to assess the value of it.

14 SENATOR HUBER: Leading to my next question, Dick. Do you
15 believe the contracts will decide which route is chosen,
16 and would you please try to give us a percentage of
17 chance for El Paso against Artic Gas, for instance?

18 MR. KILGORE: Senator, I'm really not able to give you that
19 kind -- it obviously provides some positive support.
20 I really don't know what the odds of it are. I think
21 that's beyond the scope of my competence as an economic
22 advisor.

23 SENATOR HUBER: My last question fits in with it. Leaving
24 political considerations aside, if you remove the
25 political considerations from the contracts, do you believe

1 we could get more money if we held off selling our gas
2 until a transportation system is ready instead of
3 using it for political clout? If so, what magnitude
4 would you project?

5 MR. KILGORE: As I said before, we don't really know what
6 future pricing is going to be like. We don't know
7 whether it's going to be regulated pricing, or deregulation
8 and so on. So there is an uncertain future. It has been
9 suggested there is at least a possibility that the State
10 could get a higher price by not signing this contract
11 and waiting. But when I look at the circumstances under
12 which this possibility might happen, I think it's
13 unlikely.

14 SENATOR HUBER: You think it's not the most likely scenario?

15 MR. KILGORE: That's correct.

16 SENATOR HUBER: Thank you, Mr. Chairman.

17 SENATOR RADER: Any further questions? Mr. Chatterton?

18 It's about time for a break. I assume we're just about
19 through with this witness, but go ahead.

20 REP. CHATTERTON: There are three questions, and I don't
21 know how long he's going to take to answer them.

22 SENATOR RADER: Why don't you go ahead, let's try it.

23 REP. CHATTERTON: Sir, Mr. Kilgore, let's take an assumption
24 that here last week there was a natural gas transportation
25 system between Prudhoe Bay and the South 48 and, at least

1 we will take that premise right now. Now, apparently
2 a crisis occurred in the northeastern sector of the
3 United States that has led the President to take near
4 national emergency situations, at least for transporting
5 liquefied methane between American ports in foreign
6 bottoms and Heaven knows what all we are doing, quite
7 an upset. On the premise that that straw existed, do you
8 believe that the President might even have been able
9 to legally, and I'm sure he would have, demanded Alaska
10 gas from Prudhoe Bay even though it might have made the
11 people of Alaska suffer?

12 MR. KILGORE: Yes, I think it's a possibility. In an
13 emergency situation you can't rule out that if he doesn't
14 have the power now that the Congress will legislate
15 such powers.

16 REP. CHATTERTON: Without that straw he can't do much about
17 it, can he?

18 MR. KILGORE: No, there's no way he can move the gas to the
19 Lower 48.

20 REP. CHATTERTON: You indicated, when you were giving your
21 reasons for being hired by the Legislature here and so
22 forth and so on, that you did do consulting work for,
23 I think you said, transmission companies, other foreign
24 governments. I don't know whether I singled out of
25 context transmission companies, but would any time,

1 keeping in mind the powers of the Alaska Oil and Gas
2 Conservation Commission, would you recommend to a client
3 or do you think that a client, even if you recommended
4 that he proceed to look for financing, could possibly
5 get financing for a Six to Nine Billion Dollar pipeline
6 in view of the powers of the Alaska Oil and Gas Con-
7 servation Committee?

8 MR. KILGORE: What your're asking, are these powers likely
9 to be an important stumbling block to ---

10 REP. CHATTERTON: To the financing.

11 MR. KILGORE: To the financing? No. I think those powers,
12 in and of themselves, no.

13 REP. CHATTERTON: Even though they can turn the valve and
14 shut the gas off in two years?

15 MR. KILGORE: I think if the lenders were reasonably assured
16 from their own looks and so forth at the reserves and so
17 forth, and carefully considered what they felt were
18 reasonable flows of gas without loss of pressure and
19 so on, without loss of oil, I think they would go ahead,
20 yes.

21 REP. CHATTERTON: You, yourself, or your associates have
22 not so done, have you -- made that determination?

23 MR. KILGORE: No. We are purely economic consultants.

24 REP. CHATTERTON: One more question and I'll close. Do you
25 think, by any chance, that the transmission system between

1 Prudhoe Bay and the South 48 would be financed by public
2 money?
3 MR. KILGORE: Do I think is there a possibility that in the
4 end public money or some sorts of guarantees, or something?
5 REP. CHATTERTON: Yes.
6 MR. KILGORE: I think there is a possibility, yes.
7 REP. CHATTERTON: Thank you, sir. Thank you, Mr. Chairman.
8 SENATOR RADER: Representative Hayes.
9 REP. HAYES: Thank you, Senator Rader. I want to get back
10 on the question that I was asking you about, the timing
11 for deregulation. I didn't quite pose the question
12 correctly. I think you said that you didn't think there
13 would be deregulation in the next ten years, but within
14 somewhere between ten and twenty years from now. The
15 contract actually starts on the date of delivery, isn't
16 that correct?
17 MR. KILGORE: Yes.
18 REP. HAYES: So that during the first ten years of the
19 life of the contract we might expect deregulation, going
20 back to your previous answer?
21 MR. KILGORE: It's possible, yes.
22 REP. HAYES: Thank you.
23 SENATOR RADER: Any further questions?
24 SENATOR HUBER: I have a short one that comes from a question
25 Mr. Chatterton asked.

1 SENATOR RADER: Go ahead, sir.

2 SENATOR HUBER: I just wondered, Dick, I thought maybe you
3 might have some idea. Well, here's the question.
4 How much is the reasonable flow of gas without reducing
5 oil recovery? That's in answer to the way you used it
6 in answering Mr. Chatterton.

7 MR. KILGORE: Would you repeat that, Senator?

8 SENATOR HUBER: In your opinion, how much is the reasonable
9 flow of gas without reducing oil recovery in the content
10 that you used it in answering Mr. Chatterton's question?

11 MR. KILGORE: As I said, I'm not an engineer, I don't know
12 technically the answer to that. My answer to the question
13 was, if the lenders and other people in their own analysis
14 were assured of this fact that they probably would be
15 willing to go ahead. I have no opinion of my own as
16 to what the volumes would be.

17 SENATOR HUBER: I thought it indicated to me you had some
18 knowledge that we didn't have, from your work with
19 other companies.

20 MR. KILGORE: No, sir.

21 SENATOR RADER: I think you stated, Mr. Kilgore, when you
22 started, that you've been in attendance constantly
23 during the hearings which started Monday, and that the
24 value judgments you have given us today, you have taken
25 into consideration the testimony that you have heard

1 at these hearings thus far?

2 MR. KILGORE: Yes, Senator.

3 SENATOR RADER: Are there any other questions of Mr. Kilgore?

4 Mr. Kilgore, will you be available the rest of the
5 afternoon?

6 MR. KILGORE: Yes.

7 SENATOR RADER: We'd appreciate it very much if you could
8 keep yourself available for the committee if they have
9 any questions.

10 MR. KILGORE: I intend to. I'll be happy to do so.

11 SENATOR RADER: We'll take a break and then hear from Mr.
12 Rush Moody. Ten minutes.

13 (Whereupon the hearing recessed at 3:45 p.m.
14 and reconvened at 4:00 p.m.)

15 SENATOR RADER: The committee will come back to order. Mr.
16 Jerry McCutcheon has handed me a two-page document dated
17 April 4, which he has asked to be inserted into the
18 record as an extension of his remarks as Exhibit 18
19 instead of requiring him to verbally testify. Unless
20 there is objection, we will have those remarks placed
21 in the record as Exhibit 18.

22 REP. CHATTERTON: Objection. Would you change the date to
23 February 4, please, from April 4?

24 SENATOR RADER: I'm sorry, did I say April 4? It's February 4.
25 (Whereupon Exhibit 18 was duly marked.)

1 Our next witness -- before he starts to give us his
2 own statement of qualifications, I just thought I might
3 direct the attention of the people present, as well
4 as for the record, that the February 7, 1977 Newsweek
5 entitled "The Gas Crisis" in the National Affairs
6 section, Mr. Rush Moody, a former Federal Power Commis-
7 sioner, is extensively quoted. So I want you to know
8 that Mr. Rush Moody has a national audience for sure
9 and perhaps a national constituency. I don't know about
10 that.

11 MR. MOODY: If nominated, I will not run.

12 SENATOR RADER: But, at any rate, I want to say one thing
13 about the Alaska Legislature; we go first-class when
14 we hire consultants. That's February 7, 1977 on page
15 twenty.

16 Mr. Moody, would you please -- as many of you
17 know, Mr. Moody was first retained by the State of Alaska
18 last year by the Joint House-Senate Gas Impact Pipeline
19 Committee, which was a statutory committee chaired by
20 myself and Representative Gruening as Co-Chairman.
21 Mr. Moody gave that committee extensive testimony last
22 year on some of the same matters that we're considering
23 now. The committee went out of existence as of January 1
24 of this year, the statutory committee. As I say, he
25 was retained by that committee, as was Mr. Swanson,

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from funds appropriated to that committee, with the
thought that some committee of this Legislature would
need his advice and his counsel in this matter.

So, Mr. Moody, with that, would you please
read into the record first, sir, your background quali-
fications, and then I assume you will make a statement
and open yourself for questions.

1 MR. MOODY: Thank you, Mr. Chairman, to both Chairmen, and
2 to the Members of the Committee, I wish to express my
3 appreciation for the opportunity of being here. I have
4 been most impressed over the course of the past five
5 days with the attention and the concern which each of
6 you expressed. I wish that the Congress of the United
7 States would take as seriously some of the problems they
8 have as you obviously take seriously this problem before
9 you.

10 I am a lawyer by trade. I attended the University
11 of Texas, with a Bachelor of Business Administration,
12 University of Texas Law School, licensed to practice
13 in the State of Texas in '56, in private practice from
14 1956 until 1971. I was appointed to the Federal Power
15 Commission as a Democratic member by a Republican President.
16 I served on the Federal Power Commission from 1971 until
17 March 15, 1975. I was Vice-Chairman of the Commission
18 for two of those years.

19 I resigned from the Commission in March of 1975
20 because of my belief that the structure of Federal
21 regulation was injuring the consuming public of the
22 United States and that very serious regulatory reform
23 was necessary if the country wasn't going to get in a
24 lot worse shape than it was already in.

25 Following my resignation I represented the

1 Governor of the State of Texas in Washington, as his
2 special counsel on energy affairs. In January of 1976
3 I became a managing partner of the Washington office of
4 the law firm of Vinson and Elkins. The firm, of which I
5 am a member, has offices in Houston, Washington, Fort
6 Worth and London.

7 I hesitate to claim to be an expert in any
8 area, but I am more than fifty miles from home and I
9 do have a briefcase, so I guess I qualify.

10 Mr. Chairman, I would start out, I suppose, by
11 saying that I attempted to prepare for the committees
12 a summary of the contracts together with some analyses,
13 or attempted analyses, of what I perceive to be the major
14 strengths and major weaknesses.

15 SENATOR RADER: Let me interrupt you, Mr. Moody, so we be
16 sure we don't miss that. Make certain that the remarks,
17 your analyses and your covering letter of January 28 is
18 entered in full as an exhibit to the hearings, and that
19 would be Exhibit 19; is that not correct, Reporter?

20 MRS. SANDERS: Yes.

21 SENATOR RADER: Be assured that your full remarks are in
22 the supplement.

23 (Whereupon Exhibit 19 was duly marked.)

24 MR. MOODY: Thank you, Mr. Chairman. I realized after I
25 got here and after I listened to the course of the

1 hearings over the past several days that, in many
2 instances, the issues that were being explored related
3 to whether or not any contract should be signed, whether
4 it was appropriate use of the State's resources to commit
5 to these contracts, these particular purchasers, under
6 these particular circumstances at this particular time.

7 I will, if I might, go through the more formal
8 part of my contract analysis first and then turn, if it
9 is the committee's will, to some of the other issues
10 that have been addressed during the course of the hearing,
11 and then finally respond to whatever questions the
12 committee will have.

13 With respect to the contracts themselves, I should
14 start out by saying that it is very difficult to make
15 a comparison with any other gas sales contract because
16 you have a unique situation, and much of what I can
17 offer to you, other than with reference to the technical
18 side of the contract in terms of measurement, metering,
19 and that sort of thing, I can tell you whether that's
20 standard or whether it's not standard. But there's much
21 that's in the contracts that reflect the unique nature
22 of the transaction, and so when I offer thoughts on that
23 I hope that you gentlemen and ladies will understand I'm
24 having to offer you value judgments of a sort. I didn't
25 perceive it to be my job to say this is the best of all

1 arrangements that could be made, but rather to take what
2 the Administration had negotiated and brought to you and
3 try to offer some thoughts as to where those contracts
4 seemed beneficial and where there might be questions.

5 I would speak first on the positive side with
6 reference to the contracts themselves. I find four areas
7 where I think an excellent bargain has been struck, in
8 several instances much better than I would have expected
9 in trying to plat out what course this all might have
10 taken when we first started discussing it a year ago.

11 I think one of the principal strengths of the
12 contract lies in the provisions that the State will not
13 suffer monetary loss by reason of an in-kind taking,
14 compared to what expenses the State would be out, which
15 would be none, if it just took in value. When the State
16 takes in-kind there has to be a point in the production
17 cycle when title to the gas passes. It cannot be, in
18 my judgment, at a point after all of the processing has
19 occurred and all liquids have been stripped out, and the
20 State just walk in and say, "All right, we want one-eighth
21 of the residue gas and we want one-eighth of the liquids
22 free of any costs."

23 I don't believe that's the way it's going to work
24 under your leases and under the practicalities of the
25 arrangement. But since the gathering lines haven't been

1 built and the processing plants have not been designed
2 or constructed, no one knows what those costs will be,
3 and I think it very important that the contract nego-
4 tiators realized that there was a risk, a substantial
5 financial exposure on the part of the State, and that
6 they undertook to protect the State against those costs.
7 This, in my judgment, they have done in Article II,
8 Sections 2.2 and 2.3 wherein, in effect, the buyers say
9 whatever it is that the State is out in terms of out-of-
10 pocket costs by reason of this in-kind taking, that the
11 State would not have been out if it were value taking,
12 then we, the buyers, agree to reimburse the State in full.

13 I think that was a significant concession on the
14 part of the buyers to the State, and I think it's an
15 important element of protection in the contracts.

16 Secondly, I think it is very much in favor of
17 the contracts that the arrangements have been structured
18 so that the State is selling one hundred percent of its
19 present deliverability, but not one hundred percent of
20 its Prudhoe Bay reserves. You will notice as you go
21 through the contracts that of the three buyers, one is
22 to receive twenty-five percent of the gas that flows
23 that belongs to the State, another twenty-five percent,
24 and then the third fifty percent.

25 Well, obviously, that's the full one hundred

1 percent of the deliverability as it is produced. But
2 because the volumetric limitations are written into the
3 contract in Article III, what we have is a situation
4 that the State is not selling what it really believes
5 that it has in totality. In this instance I operate on
6 the strength of what I was told last year when I was
7 up here, that the State's royalty share of recoverable
8 reserve was anticipated to be in the order of 3.2 trillion
9 cubic feet, and these contracts obviously sell less than
10 that. So it's less than a complete sale of all of the
11 royalty gas that the State expects to recover from Prudhoe
12 Bay.

13 Personal judgment, I think that is prudent
14 because it gives you an opportunity to have some operating
15 experience behind you, it lets you see what the market
16 conditions are like at that point in time when the total
17 volumes have been delivered under these contracts, and
18 permits you the flexibility and freedom to make new
19 contractual arrangements if that appears to be in the
20 best interests of the State.

21 Third, I think the arrangements for withdrawal
22 of gas for in-State needs are very favorable. I think
23 the protection there is quite good. I will express to
24 you the view that these provisions may almost be too
25 good when it comes time to try to finance construction

1 of a pipeline. It's going to be a little bit hard for
2 a financial institution to look at a situation where
3 the State has a right to pull back out one hundred per-
4 cent of one-eighth of the gas stream, so that that through-
5 put is not available to stand behind the generation of
6 revenues for the line.

7 From a contractual standpoint, I see no reason
8 in the world not to insist upon this bargain as far as
9 the State is concerned. What I'm suggesting to you is
10 that there may come a moment of truth further down the
11 line when the financial institutions come to the State
12 and say, "If you insist on this we can't finance it."
13 To me, I'm trying to underscore what I believe to be
14 the strength of the withdrawal provisions because I think
15 they are very favorable to the State.

16 I am impressed with the provisions in the contracts
17 relating to the retention of the State's rights in natural
18 gas liquids. You've heard a number of people say, and
19 certainly I agree with them completely, that the liquid
20 content of this gas may be of greater value to the State
21 than residue gas itself. I do think that the State has
22 retained fully the right to remove the liquids, process
23 them and do with them as they will.

24 You're not forced to do that. It's an option
25 under Article IX. If you leave any part of the liquids

1 in the stream the buyer has to take them; you, the State,
2 will be compensated on the basis of the increase in btu
3 content of the gas that comes about by reason of leaving
4 the liquids in the stream. So you, in effect, have an
5 option as to whether to pull the liquids out or to leave
6 them in. If you pull them out, they are yours to sell
7 on the open market or to devote to uses within the State.
8 If you leave them in you will be paid for the btu content.
9 I think those provisions are quite protective of the
10 State's interests.

11 Finally, I read with interest the different places
12 in the contracts where the State has the right to with-
13 draw or terminate because, since we are dealing in such
14 such a flexible fluid situation, I would think it
15 important to the State to know that they were not forever
16 bound to these contracts, that if certain things happen
17 that you might walk away from them without incurring any
18 obligation or liability.

19 There are, I believe, four instances where the
20 State can withdraw from the contract without penalty.
21 It may do so if it is prevented by a Federal action
22 from taking its royalty gas in-kind. The contracts may
23 be terminated if a decline in production results in
24 non-profitability to the State. The sales agreements may
25 be terminated by the State if the State so elects after

1 the FPC makes a routing decision that is adverse to an
2 all Alaskan line, and finally, the State may terminate
3 if by January 1, 1979, all approvals necessary, authoriza-
4 tions, that the State feels necessary to get the benefits
5 under this contract, if all of those approvals have not
6 been received.

7 I think the latter quite a good provision. I
8 think it lets you look at the decisional process at the
9 Federal level. If it's something that the State could
10 live with, you may do so; if you don't like the way it's
11 structured, you've got the right to terminate the agree-
12 ments. I think those provisions are all quite sound,
13 quite protective of the State, and I think they are
14 major sources of strength in the contracts.

15 The principal areas of difficulty that I have
16 with the contract all relate to Article VI, dealing with
17 pricing. There are several problems here. I've tried
18 to be as exhaustive as I could in thinking up the problem
19 areas that you need to be aware of. In the course of
20 talking about them though, I'd like to give you an
21 assessment as to whether I think they're problems of
22 great magnitude or problems of lesser magnitude -- because
23 any lawyer can find anything in a contract, you know, and
24 say, "This might not work out too well." So I'll do the
25 best that I can to give you an assessment of how bad

1 it is as we touch upon each one of them.

2 The first one relates almost directly, Representa-
3 tive Gruening, to the line of questions you were asking
4 about the possibilities of a deregulation bill or any
5 action that would result in a vintaging situation that
6 would be hurtful to the State. The structure of Article
7 VI is such that there is a proviso in Section 6.1 which
8 has overriding effect on the pricing structure. I'm
9 sure that each of you have read these contracts carefully,
10 and you will recall that Section 6.2 provides a pricing
11 mechanism if regulation continues.

12 6.3 provides a pricing mechanism if there is no
13 Federal regulation, and 6.4 provides a pricing mechanism
14 if Federal regulation starts, deliveries commence, and then
15 Federal regulation terminates. So there are three
16 alternatives, really, in terms of pricing, and then
17 you pick up Section 6.5, which is important and which
18 gives redetermination rights.

19 But Section 6.1, the last clause makes it clear
20 that there is one condition that cuts across all of the
21 pricing alternatives, and it is that so long as the
22 pipeline buyers are subject to the jurisdiction of the
23 Federal Power Commission, so long as their rates are
24 subject to the jurisdiction of the Federal Power
25 Commission, then the price that they will pay to the State

1 shall be no higher than the price which they are per-
2 mitted to recover in their jurisdictional rates at the
3 FPC.

4 I'm not surprised to find that the pipelines
5 wanted that, because certainly you can understand that
6 they don't want to pay you more than they can get back
7 from their customers and, indeed, I would be surprised
8 if all pipeline purchasers didn't bargain most strenuously
9 for this type of provision. But I do want you to be
10 aware that the effect of it is to say that so long as
11 deregulation does not occur the Federal Power Commission
12 is going to be setting the price for your gas.

13 So far the State has taken the position that it
14 is not a person within the meaning of the Natural Gas
15 Act, that it is not subject to direct rate regulation
16 by the FPC. I concur in those positions, but the effect
17 of Article 6.1 is to consent to indirect rate regulation
18 by the FPC because you are saying that the pipelines
19 do not have to pay to you more than the FPC will permit
20 them to flow through in their jurisdictional rate structure.

21 That problem disappears if appropriate deregula-
22 tion legislation is passed. But if it does not pass, if
23 we are with substantially the same form of pricing that
24 we now have for some period into the future, then it seems
25 to me that the 6.1 proviso does override the other pricing

1 alternatives that appear in the contract. Because of
2 that, Representative Gruening, you can postulate a situa-
3 tion where a deregulation bill passes that deregulates
4 the producer but does not deregulate vintage of gas that
5 the State would be selling under this contract. That
6 would occur if a deregulation bill were drawn so as to
7 deregulate gas sold under a contract dated after a
8 certain date.

9 I offer you the value judgment that that is a most
10 unlikely occurrence. The Commission moved away from
11 contract date vintaging in 1969 in the Southern Louisiana
12 Two decision and has never returned to it. I believe
13 that I have read every piece of gas legislation that's
14 been offered in either House for the last four years,
15 and I can recall no bill offered in either House that
16 went to deregulation on the basis of contract alone.
17 They are mostly cast in terms of new gas being defined
18 as gas sold under a contract or delivered after a certain
19 date, and it's an "or" delivery test. I don't really
20 think it's likely at all that a deregulation bill would
21 be cast so that it would be harmful to you.

22 As a practical matter, so that you will under-
23 stand why the Congressional reasoning and the FPC
24 reasoning seems to be moving in this direction, away
25 from contract vintaging, it is simply because if you

1 permit a deregulated price to a producer on the basis
2 of when he contracts to bring the gas to market, if that
3 producer has been guilty of withholding his gas from
4 market in anticipation of deregulation, then you have
5 rewarded his wrongful conduct.

6 So, to me, it's not likely that people are going
7 to go back to contract date vintaging as a test for
8 deregulation. So my answer to the line of questions
9 you posed is that there is, yes, a theoretic possibility
10 that the State could be hurt by contract date vintaging in
11 deregulation, but I do not believe that that possibility
12 is substantial.

13 I do think that the present language of Section
14 6.1 is unclear in one respect. In my opinion letter,
15 on pages six and seven, I attempted to spell out why
16 I thought there was an ambiguity. I think, from my
17 discussions with Mr. Byrd, that the parties did not
18 intend the ambiguity to exist and it would be probable
19 that the buyers would enter into whatever type of
20 letter modification or letter of explanation that is
21 necessary to straighten this out.

22 It seems to me that it must be made clear
23 that Section 6.1's limitation goes out the window,
24 becomes totally inoperative, if an appropriate deregulation
25 bill is passed. I just don't think that the language

1 is altogether as clear as it could be on that point,
2 but I don't think it's a major burden or a major obstacle
3 to the contracts if the purchasers will agree as to what
4 the proper construction of that provision is.

5 Other witnesses have advised you, and certainly
6 I agree, that you cannot determine a sales price under
7 these contracts as drawn. Section 6.2 will not give you
8 a sales price because the FPC has set no price for Alaska.

9 Section 6.3 and 6.4 will not give you a price
10 because they're conditioned precedent, deregulation, has
11 not occurred. And so you have before you a contract that
12 is indefinite as to price, and you have a contract where
13 your price will ultimately be determined by someone other
14 than the State. In the event of continued regulation
15 your sales price will be determined by the FPC. In the
16 event of deregulation your sales price will be determined
17 by the prices which producers, working interest owners,
18 obtain in their contracts.

19 So, I would want you to understand that you
20 are giving up direct State control over the sales price
21 through the pricing mechanism embodied in Article VI.

22 There have been a number of comments about
23 whether we will or will not have deregulation, and if we
24 have continued regulation, what is likely -- I'm mentioning
25 at this point, because it's structured into my opinion

1 and I think it is a major concern.

2 So many things have happened so fast in the Lower
3 48 States in the natural gas business over the course
4 of the past three or four weeks that I don't think any-
5 body can give you an informed guess as to the likelihood
6 of deregulation or not. We've seen two and a half
7 million people out of work on a given day in the Lower
8 48 States because there wasn't enough natural gas to go
9 around. We've seen the Congress in three days' time
10 pass an emergency allocation bill that for the first time
11 gives the President of the United States the right
12 to reach into one interstate pipeline supply sources
13 and move the gas to another interstate pipeline.

14 We've seen as of, I think it was Wednesday night,
15 the President authorized Two Dollars and Twenty-Five
16 Cents as an emergency purchase price that any interstate
17 pipeline could pay for one hundred and eighty day emergency
18 purchases of gas anywhere in the Lower 48 States.

19 All of this says to me that it is a time of
20 great uncertainty. We will nationally, I suppose, sooner
21 or later arrive at a decision whether we're going to move
22 toward greater regulation and allocation on a national
23 scale, or whether we move to less regulation and honoring
24 of private contracts. I wish I had an answer for you,
25 because I think if you knew what the future held, it would

1 make your job a lot easier.

2 But I cannot, in honesty and in good conscience,
3 tell you that I'm confident what the future will bring.
4 If deregulation continues, or if a deregulation bill is
5 passed that is not appropriate to Alaska, and by that
6 I have reference to the possibility that a bill might
7 be structured like FPC and go to commencement date of
8 a well rather than date of first deliveries. So you
9 might have some gas up there that continues to be regu-
10 lated even though a deregulation bill passes. But if
11 some or all of your gas remains regulated, I hate to say
12 it but I must say it, brace yourselves -- my judgment
13 would be that the Federal Power Commission will determine
14 a rate for Alaska as a separate producing area, that
15 they will not treat you on the same basis with the
16 national rate, as they treat the rest of the country.
17 They have specifically excluded Alaska from applicability
18 of their last set or rate orders, they have specifically
19 excluded Alaska data from the calculation of a national
20 rate, and to me that indicates that when the time comes
21 for the setting of an Alaskan rate, it will be a rate
22 peculiar to Alaska.

23 I am concerned, and I would want you to understand
24 the reason for my concern, that an FPC separate for the
25 State of Alaska will probably be not as high as Judge Litt

1 and they came up with a very low rate, relatively
2 speaking, for associated gas. You can understand it.
3 Gas was their responsibility, they could keep the price
4 down and make everybody happy by putting the costs over
5 on the oil side; so that's what they did.

6 The second factor that you've got going against
7 you is that you do have a major, huge discovery up here,
8 and obviously the more units of gas you have in terms
9 of reserves added, the more units that you have to spread
10 these costs over, then you come up with a lower per unit
11 cost figure. So the arithmetic of FPC methodology is
12 against you if they're going to set the rate for you. I
13 can't really do much more than say that the structure
14 and the methodology is just going to work against you;
15 that's all there is to it.

16 But that is a condition beyond my control, or
17 yours. It is only one of those things that you need to
18 be aware of. That condition would exist whether or not
19 you sign these contracts. The existence or the absence
20 in the Federal regulation is not, obviously, going to
21 turn on whether these contracts are signed or whether
22 they are not. But in speaking with you today, I at least
23 want to mention to you that it would appear to me that
24 the State of Alaska needs to be very active at the FPC
25 in any rate matters affecting Alaskan gas, because if you

1 mentioned in his opinion, of a Dollar, probably not be
2 as high as some of the economic projections that have
3 been laid before you over the course of this past week.
4 And the problem essentially arises because of the structure
5 of rate making methodology at the FPC. They try to set
6 a rate for natural gas on the basis of what they perceive
7 the cost of production to be, the cost of finding and
8 production, and a reasonable rate of return to the
9 producer.

10 They have, since 1968, been costing gas well gas
11 where they could find a data series and they could
12 determine how many feet were drilled in gas well explora-
13 tion, what gas reserves were found, what the costs of
14 gas production were. So their national rate determina-
15 tions since 1968 have essentially been for new gas well
16 gas.

17 You go back to the early Commission efforts at
18 rate regulation when they tried to price associated
19 gas, and they became enormously tangled up with the
20 problem of cost allocation. Here are two joint products,
21 oil and gas, they come out of the same hole in the ground,
22 you spent a certain number of dollars to find it and
23 produce it, so how do you allocate the cost between the
24 two products. The FPC, since they had jurisdiction over
25 gas, allocated a very heavy burden of costs to the oil,

1 leave it to them to do it for you without some evidence,
2 and some input and some argument from you, you are
3 probably not going to like the results.

4 I did have a problem with the redetermination
5 provisions under Section 6.5. They were the same concerns
6 that Mr. Swanson raised with Chairman Rader the second
7 day of the hearing; and with the purchasers' representa-
8 tions about their meaning of Section 6.5, I no longer
9 find an objection in that area.

10 Over all, to get back to the general structure
11 of the thing, since your rate is going to be determined
12 by somebody else, one consequence of entry into these
13 contracts will be the necessity that the State partici-
14 pate in some FPC proceedings. Your rate, under this
15 structure, in the event of continued regulation will
16 be set either in a national or an Alaskan rate proceeding
17 where the FPC determines by rule-making a rate applicable
18 to the whole state, or it will come up in an independent
19 individual producer's certificate case where one of the
20 North Slope producers goes finally into the FPC with a
21 contract and says, "Here is the price I bargained for.
22 Let me charge it." And the FPC can approach the rate
23 issue in that context.

24 Or, finally, if neither of those two things
25 occur and deliveries commence, the pipelines that buy

1 from the State will take to the FPC their rate structure
2 and ask for approval of what they paid to the State.
3 There are three possible procedural mechanisms where the
4 pricing problem can be reached by the FPC. Whichever
5 of those three comes to pass, it seems to me absolutely
6 essential that the State be there to participate fully.
7 I don't think you can rely on other people to carry
8 this important issue for you in that fort.

9 On the whole, if you asked me whether the pricing
10 problems that I've tried to outline for you are sufficient
11 to condemn the contract, I'm going to give you one of
12 those "either/or" answers, I think. I'm not sure that
13 what we're talking about here is a pricing issue, in
14 terms of what the Legislature is going to be asked to do.
15 I think it's a routing issue.

16 Having already stated that these contracts are
17 unique and that, therefore, there's not much I can compare
18 them with, I offer you the value judgment that I don't
19 think you'll get better terms than this from anybody
20 at this time and under these circumstances. I think
21 that on the whole they're as good a contracts as you are
22 likely to get.

23 The real question, it seems to me, and here I
24 need to, I guess, go back a little bit -- I did come up
25 here this time thinking that the State had already made a

1 decision about which route it supported and that the
2 sale of the gas was an appropriate means to try to help
3 influence a favorable decision on the routing. I can
4 well understand it, because a lot of things that have
5 occurred in the last year that many members of the
6 Legislature and many citizens in the State might want
7 to think through again, whether those are both questions
8 that you would still answer in the affirmative. But if
9 you come to the same answers and you say, "We do think
10 that the routing decision is important to the State,
11 we do think that the State should do all that it can
12 to influence a favorable routing decision," then I sus-
13 pect that the pricing provisions here should not be a
14 bar to your approval. But I can't -- and I'd make it
15 perfectly clear to you, you've got a third applicant
16 in the game since I was here a year ago. I carry no
17 brief for El Paso or for Alcan, I carry no brief for
18 the individual purchasers under these contracts. Pick
19 Tenneco, Southern, anybody else -- I'm just trying to
20 speak to the concepts of what are you doing with the
21 State's resource and is this a good time to do it.

22 I think there is a risk in not doing anything.
23 I cannot tell you, and I don't think anybody else can
24 tell you, how much it will influence the routing decision
25 if these contracts are approved. I think, as Mr. Ward

1 said the other day, that most people would recognize
2 that it will have some impact. I don't think, and this
3 kind of disturbed me, about the way things sounded a
4 time or two. I don't think what we're talking about is
5 the State trading its royalty gas for lobbying efforts
6 by two companies.

7 It seems to me what I was talking about a year
8 ago and, hopefully, what everybody is thinking about,
9 is that the State is holding out to a number of states
10 in the Lower 48, "We will share our gas with you if you
11 will help us get the route that we need." I have a
12 jaundiced and prejudiced view, I suppose, of lobbying
13 as such, if a corporate vice president thinks he's
14 going to influence a Legislator's vote. I don't think
15 that happens very often. I don't think that's the way
16 to get things done anyway.

17 But I don't perceive these contracts as a means
18 where you buy a corporate lobbying support and expect
19 you're going to get anything. If you look at it that
20 way, I don't think you will get anything. But if these
21 purchasers, in your judgment, are responsible companies
22 that know their business and can reach to their customers,
23 and go to their customers and say, "We have the promise
24 here in writing of some gas from Alaska if we help
25 Alaska on getting the right route," then it seems to me

1 you've got to have some influence on the routing decision.

2 I think Judge Litt has spoken the first word,
3 but most assuredly, he has not spoken the last word
4 on the routing problem. An Administrative Law Judge
5 of the FPC, and particularly Judge Litt, is respected
6 by the Commissioners. They will believe him to be an
7 honest man who has worked diligently with the record
8 over many months, and I would anticipate that they would
9 think that he is infinitely more familiar with the record
10 than any of them can hope to become. But they will not
11 abdicate their responsibilities to Judge Litt. I say
12 that institutionally and I say it knowing the individuals.
13 I think they will try their best to reach a decision on
14 what they perceive to be truly in the national interest.

15 Certainly I think the same will be true when it
16 moves over to the White House for Executive Agency decision.
17 So I don't think the routing decision dies with Judge
18 Litt's decision. I think it's still an open issue. I
19 think it's possible that some persuasiveness can still
20 be brought to bear on the issue.

21 Really, I don't ask myself so much, "Is it too
22 early to enter into these contracts," as do I ask myself,
23 "Is it too late that we entered into these contracts?"
24 Once again, I'm not talking about individual buyers
25 (I hope you all understand that), I'm talking about

1 the concept of the use of the State's royalty gas as a
2 means of trying to influence what you believe to be in
3 the State's best interest, and whether you come down
4 on the side of Alcan or El Paso, that's beyond my concern
5 and beyond my knowledge.

6 Whatever you do, it seems to me, perfectly legi-
7 timate that you use the State's resource in a manner
8 that helps you get the best benefit for your State.

9 I preach a lot, I apologize. I guess I feel
10 strongly about your situation up here because you're
11 one of the few places that still has the opportunity
12 of controlling your own destiny.

13 There are a couple other things that I guess are
14 worth mentioning. I don't try to characterize them as
15 good or bad since I think that your perception of them
16 depends on things other than legal analysis. But I think
17 the provisions of 11.4 are noteworthy, which grants to
18 the Governor the right, in effect, to make a switch in
19 the State's support. I really can't offer any judgment
20 as to that provision. Certainly you have to be aware
21 of it.

22 The contracts do contain certain options on
23 State royalty gas that are triggered if the State effects
24 a withdrawal of some of the gas covered by these contracts
25 for in-State use. I think the option provisions, themselves,

1 are not remarkable and are understandable. I suspect
2 that they reflect the necessary bargaining process of
3 what State negotiators had to give up in order to get
4 some of the stronger elements in the contract that I
5 covered earlier. So I mention it only to make sure that
6 I've tried to make you aware at least of the major pro-
7 visions in the contract.

8 The contract is silent on one thing that I think
9 is significant, and I'm probably beyond my depth here
10 and, therefore, going to make a mistake or two. But
11 my recollection of your severance tax structure is that
12 if you take your gas in-kind, the one-eighth taken in-kind
13 will probably not bear a severance tax. That is a sub-
14 stantial revenue loss that occurs by reason of an in-kind
15 taking that would not occur if you took in value, and I
16 don't think the contract deals with that. I don't think
17 that the questions asked to the purchasers the other
18 day, in effect were, "If you pay a severance tax com-
19 ponent to a working interest owner will you match that
20 and will you pay it to the State," and they said, "Yes,"
21 and that's fine.

22 In the event of the continuance of regulation
23 they will be permitted to pay a severance tax component
24 only as reimbursement for severance tax pay. So I don't
25 think that the FPC will let them pay you the equivalent

1 of a severance tax component. So I do suggest, as I
2 think one of the other folks did this morning, that it
3 might be appropriate for the State to give some thought
4 to its severance tax structure in conjunction with these
5 sales arrangements.

6 One or two general thoughts, if I might, maybe
7 it would save some time, before we get to individual
8 questions.

9 I think several of you have indicated an interest
10 in knowing whether or not these same or better terms
11 could be obtained if the State waits until a later date
12 to make a sale. I suspect that if the routing decision
13 is adverse, if Arctic Gas is selected, I don't think
14 you'll get these favorable terms because I don't think
15 that your rights of withdrawal will be meaningful to you,
16 and I'm not sure that a purchaser through that system
17 would consent to it.

18 I'm not sure that you could get the same provisions
19 on the reimbursement of costs incident to your in-kind
20 taking. In essence, the four areas that I thought
21 represented real bargaining pluses in the contracts, it
22 seems to me if you're talking about a buyer through the
23 Gas Arctic system, they have little reason to offer you
24 those favorable terms. So it may be that waiting until
25 a later date, in the event of an adverse routing decision,

1 you might not see terms as favorable as these again.

2 Some questions have been asked as to whether or
3 not the State could obtain a higher price if they pursued
4 some other type of sales arrangement. Again I have to
5 offer you a value judgment because I haven't surveyed
6 the market. There's not any real way that I could do
7 that, but I can speak with reference to how sales arrange-
8 ments are structured under FPC regulation. And I will
9 say that any sale that you make to someone in the Lower
10 48, or in the State of Alaska, is going to involve FPC
11 transportation jurisdiction and, in a sense, that sale
12 is going to be subject to FPC review.

13 If you attempt to find a distribution company
14 in the State of Alaska or outside the State of Alaska
15 to sell to, yours will be a sale for resale in interstate
16 commerce, and the transportation of the gas will be in
17 interstate commerce. So I don't really think that you
18 move beyond where you are now by looking for that type
19 of purchaser. There are not many purchasers that are
20 able to take the volumes of gas that you all are talking
21 about delivering, so you've got, in one sense, a limited
22 market.

23 Electric utilities, I'm sure, would love to have
24 it to burn under boilers, but I am quite positive that
25 the FPC would never grant transportation authority for

1 that type of use.

2 The FPC does have a procedure whereby high
3 priority users can purchase gas from a producer. It's
4 called Order 533(a). It is limited to two years. The
5 buyer is supposed to receive only those volumes that
6 offset his curtailment in high priority two and three
7 usage, and I think it's just simply not applicable to
8 the type of sale that the State would be looking to.

9 So, while I will not absolutely rule out any
10 possibility of a sale at a higher price, I offer you
11 the value judgment that you probably won't find one.

12 One of the Representatives the other day indicated
13 that perhaps Section 13-B of the Alaska Natural Gas
14 Transportation Act rendered the desirability of these
15 contracts somewhat less than might have been true before
16 the passage of that act. It seems to me that 13-B is
17 helpful to the State only if the right route is selected.
18 If the gas moves out of the State north of the Arctic
19 Circle I don't know how you would ever implement your
20 rights of withdrawal. You're just not going to have a
21 means of getting it down to where your people are and
22 where you hope your industry is. So it will look good
23 on paper. It doesn't vanish if the Gas Arctic route
24 is chosen, but it is hard to see how it is of much
25 practical help to you.

1 I will confess to a certain academic interest
2 over the last few days in the discussions that you all
3 have heard with reference to the effect of transportation
4 costs on wellhead prices. It's a very confusing area,
5 and I will offer you my perception if you want it.

6 In a regulated market, transportation costs are
7 not going to have a thing to do with wellhead price.
8 The FPC is going to set a wellhead price based on what
9 they perceive to be the costs of finding and production,
10 and a reasonable rate of return to the producer, and they
11 simply have no mechanism for looking at transportation
12 costs as a function of that rate. I know of no instance
13 that the FPC has ever set a producer rate based upon any
14 consideration of transportation costs.

15 In the event of a non-regulated market, I think
16 that what I have heard over the last several days with
17 two sides of the argument, I've heard some truth on
18 both sides, but I'm not sure that I've heard the complete
19 truth from either side, and I mean no disrespect,
20 obviously, by saying that. In a deregulated market
21 transportation costs do have an influence, but they are
22 not the only factor that influences wellhead prices.

23 The nature of the use to which the gas is going
24 to be put determines whether it is appropriate to look
25 at a number two fuel oil equivalency price. For some

1 uses a user will pay much more than a number two fuel
2 oil price. So you have to look at the market to which
3 the gas is going before you know what is your base point
4 for comparison backwards, and in the absence of a funda-
5 mental change in regulation the average cost of purchased
6 gas on a pipeline system is buying from you has an
7 influence on the wellhead price in the sense that, indeed,
8 regulatory agencies now tell a pipeline or distributor,
9 seller, to roll in or average his costs. And if you're
10 dealing with a buyer that has a low average cost to
11 purchase gas, then what he pays you is influenced by
12 the fact that he's working against a lower averaging base.

13 I guess what I'm saying is that in the event
14 of deregulation, if you tried to determine wellhead
15 price only by looking at transportation costs and only
16 by equivalencies with number two fuel oil, I suggest
17 that's less than all of the factors that will enter into
18 it. I suspect that as of right now, trying to determine
19 what wellhead price will be in the event of deregulation
20 is largely a metaphysical exercise. I'm just not sure
21 that it's productive. You'll get as many guesses as you
22 get economists up here.

23 Now, we lawyers are more definite, you see.
24 I'm sorry I've taken more of your time than I intended
25 to. I guess, Mr. Chairmen, it would be appropriate

1 to offer myself sacrificially.

2 SENATOR RADER: Representative Rudd.

3 REP. RUDD: Mr. Moody, this morning Mr. Swanson mentioned
4 the possibility of storing our gas in place for some time,
5 until we have a need for it. Is that a possibility if
6 we don't approve these contracts? Is that a possibility?

7 MR. MOODY: Well, I guess there are two sides to the question.
8 Is it possible mechanically, physically?

9 REP. RUDD: I was going to ask both questions.

10 MR. MOODY: And is it possible ---

11 REP. RUDD: By law.

12 MR. MOODY: Regulatory. I better not make a guess on the
13 first one because I really don't know enough about your
14 reservoir and its mechanics, that I really couldn't give
15 you anything of value other than to guess on it. On the
16 other side of it, once again you've got to make a judgment
17 as to whether we're going to be deregulated or continue
18 to be regulated. Since my personal feeling is that we
19 probably are going to face regulation, I think I'll deal
20 with that one first.

21 If the producers start selling the gas stream
22 into interstate commerce you would have to be most careful
23 that some type of balancing arrangement or under-lifting
24 arrangement with the producers had been reduced to writing
25 and had been approved by the FPC, because in my judgment,

1 if eight-eighths of the gas stream starts flowing in
2 interstate commerce without some advance approval for
3 the State to be storing its gas having been had and
4 obtained from the FPC, you would be met with the argument
5 when you later wanted to change the flows that you were
6 trying to work an abandonment and that Section 7-B of
7 the Natural Gas Act would interfere with what you wanted
8 to do.

9 I think it's something that perhaps could work
10 but I think you need specific agreements and, to be on
11 the safe side, I think you'd want to go for regulatory
12 proof.

13 REP. RUDD: Could you give us your appraisal as to how
14 likely it is the FPC would agree to such an arrangement?

15 MR. MOODY: I'd guess they wouldn't. I think they want your
16 gas.

17 REP. RUDD: Would this hold true under both conditions of
18 the Alaska exemption, whether it's in effect or not in
19 effect? Would that have any bearing, do you think,
20 on their decision?

21 MR. MOODY: I read Section 13-B to apply to withdrawal from
22 the system after deliveries have once commenced. Maybe
23 that's too narrow a reading. Assuming 13-B stays in the
24 Act and your arrangements for storage were structured as
25 part of a royalty sales contract, I guess you could

1 bring it within 13-B.

2 REP. RUDD: Thank you. I have one more question on another
3 subject.

4 SENATOR RADER: Go right ahead.

5 REP. RUDD: I think it was Mr. Thompson who mentioned yester-
6 day or the day before, that he felt that a lobbying
7 effort in Washington would not really be a very important
8 thing to do at this time because it is now a decision
9 that is before the FPC and then the President, and
10 Congress only gets into it after those two have made
11 their decisions, and only has a very short time to
12 evaluate the President's decision and, therefore, probably
13 will not go against the President's decision. But
14 you're a former Commissioner on the FPC, and you just
15 mentioned that you thought that lobbying efforts would
16 be valuable. Are you talking about influencing the
17 decision of the FPC and the President and the Congress,
18 or at what point do you think the lobbying would be most
19 effective?

20 MR. MOODY: I'm going to, if I may, take exception to the
21 word "lobbying".

22 REP. RUDD: I'm sorry.

23 MR. MOODY: No, really. Because to me it has a specific
24 connotation; perhaps it doesn't to others. What I
25 suggest will happen is that the Federal Power Commission

1 has been told to gather all the information they can
2 in order to make the most advised recommendation to the
3 President as they can, and the President and the Executive
4 Branch has been told to gather all the information that
5 they can, talk to as many people as they can.

6 I think those people are genuinely interested
7 in arriving at the best decision they can. I would not want
8 to believe, and I do not believe, that their minds are
9 made up. I don't think that there is anything wrong
10 with offering the views of concerned people, both at the
11 FPC and to the people in the Executive Branch that are
12 charged with this responsibility. I think that the
13 opportunity still exists for people other than the State
14 of Alaska and people other than El Paso, who have made
15 their record, to go in and say, "We do have an interest
16 and here's what it is, and we'd like for you to take us
17 into consideration," and I think the opportunity exists
18 both at the FPC and in the White House.

19 REP. RUDD: Thank you.

20 SENATOR RADER: Any further questions? Representative Hayes.

21 REP. HAYES: Thank you. Mr. Moody, you mentioned that one
22 of four pluses that these contracts have -- interested me.
23 One in particular that's of interest to many of us here
24 is the right to withdraw our royalty gas for in-State
25 use after it's originally injected into the pipeline

1 system. Then you mentioned that when we get around to
2 the financing that Alaska may have to face a moment of
3 truth. Does that mean that we may have to subordinate
4 that particular clause in order to make it possible for
5 the pipeline companies to build this line and, if so,
6 what do you think the chances are that we'll have to do
7 that?

8 MR. MOODY: Well, I hate to borrow trouble, but I can see
9 that a financial institution wouldn't be too wild about
10 lending on an eight-eighths pipeline knowing that one-
11 eighth of the through-put can be withdrawn at any time,
12 because it's the through-put that generates the revenues
13 that pay back the debt.

14 I guess I'd just be guessing if I said I know
15 they're going to come to you and make you give it back.
16 The best I can do is offer you the view that to me,
17 representing the lender, you know, I'd say, "Gee, we'd
18 better go get this straightened out some way, we'd better
19 get some means of determining that the whole financing
20 of the line is not going to be in jeopardy."

21 REP. HAYES: So we have three pluses and a possible plus.

22 MR. MOODY: From a contractual standpoint you've got a very
23 good plus. My point is that it may be too strong a plus.
24 You may have to give some of it back.

25 SENATOR RADER: That was my understanding of what you were

1 saying too, that we drove such a hard bargain that these
2 people may not be able to finance the pipeline with what
3 they have left.

4 MR. MOODY: To me it's quite conceivable it could deveop
5 that way.

6 SENATOR RADER: Representative Gruening.

7 REP. GRUENING: Is the project so marginal in your view
8 that what we do with our one-eighth will kill the project?
9 I mean, can I fairly infer that from what you said?

10 MR. MOODY: No, I have no judgment about the economics of
11 any of the three projects. I've never sat down to study
12 them.

13 REP. GRUENING: But you're saying as it relates to private
14 financing that our one-eighth is crucial.

15 MR. MOODY: I'm saying that from the standpoint of a lawyer
16 who has done a little bit of work in representing lenders
17 that any time you see something that threatens the
18 revenue flow that you're looking to for repayment of
19 your debt, you raise a red flag. But then I don't know,
20 I have no judgment as to whether the difference between
21 your one-eighth and eight-eighths is the difference in
22 "go" or "no go" on the line. I'm sorry, I have never
23 done any economic studies on it.

24 REP. GRUENING: But what you are saying though, it is the
25 difference between "go" and "no go" as to whether a