SCOMM

#16:1

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April 11, 1978

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

Dear Elke:

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

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

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

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

Sincerely,

Marv Clement

M. Clement, Principal Investigator

Ward H. Swift

W. H. Swift, Manager
Alaska Projects

Attachments

AGO 545433

QUESTION 1a

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

ANSWER

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

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

Milestone 3 (18 months)

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

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

Milestone 5 (30 months)

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

Milestone 9 (72 months)

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

AGO 545435

QUESTION 1b

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

ANSWER

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

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

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

AGO 545436

QUESTION 1c

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

ANSWER

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

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

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

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

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

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

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

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

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

QUESTION 2

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

ANSWER

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

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

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

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

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

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

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

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

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

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

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

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

QUESTION 3

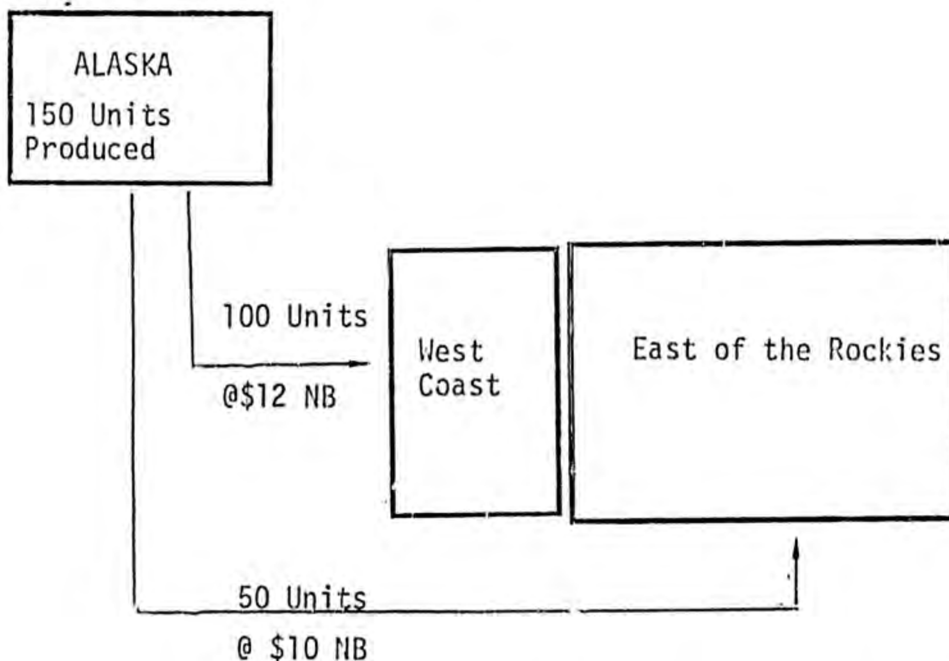
Please review the provisions governing the price to be paid by ALPETCO (Article VIII), and comment on the actual effect of the calculation method contained in Exhibit "B".

ANSWER

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

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

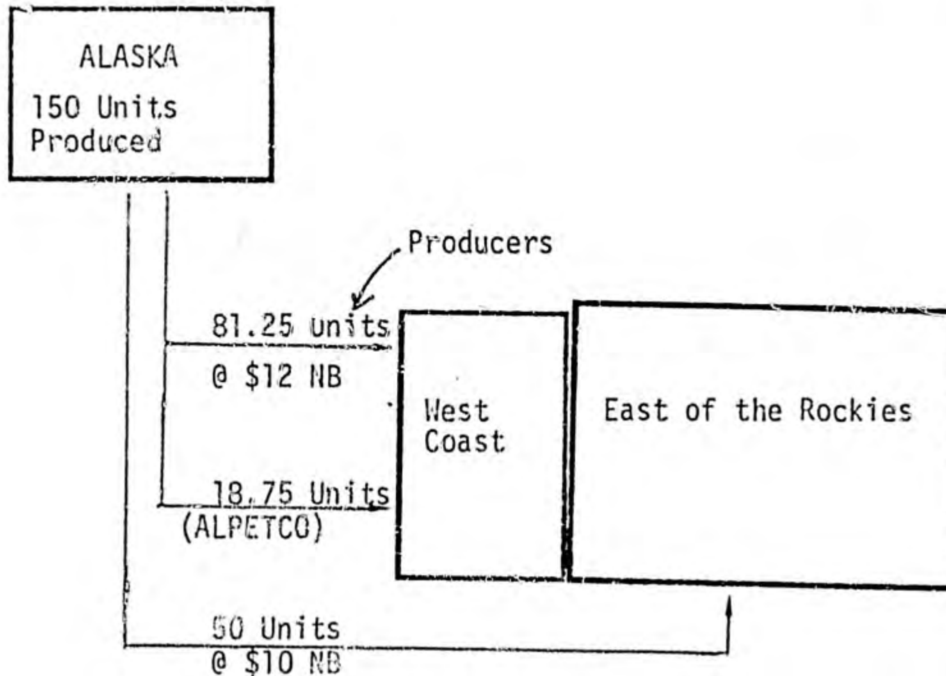
CASE A: ALPETCO Not Marketing Crude on West Coast



Weighted Average Net Back $11.33

AGO 545443

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



Weighted Average Net Back $11.23

reduced

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

QUESTION 3a

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

ANSWER

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

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

QUESTION 3a

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

ANSWER

Presumably the State could offer future royalty oil for less than what ALPETCO is required to pay for Prudhoe oil if such future royalty oil had an in-value price less than that for Prudhoe Bay oil. This condition would occur for new oil discovered, produced, and taken in-kind in ~~more~~ less remote regions than the North Slope resulting in a lower point of delivery price. However, ALPETCO would be interested only if their net refinery gate price would be lower taking into account transportation costs and any differential entitlements treatment.

AGO 545446

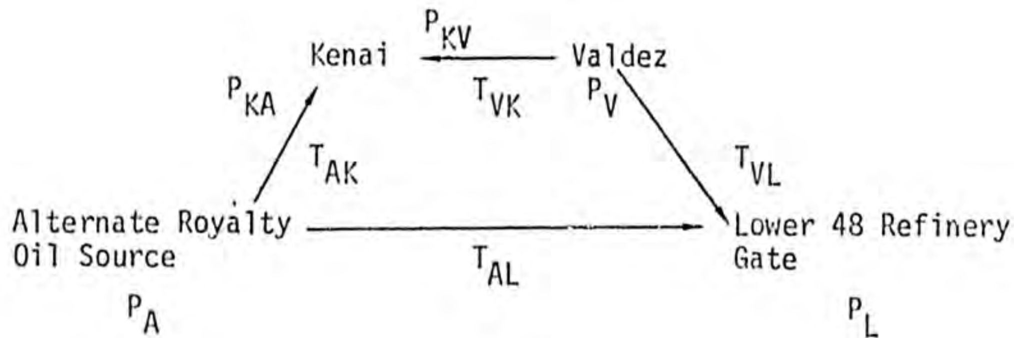
QUESTION 3b

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

ANSWER

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

Several circumstances could develop that would result in Article 2.3 coming into play. (1) The first circumstance can be diagrammed as shown below and the conditions developed through the following calculation:



In the above diagram

P_L = the lower 48 refinery gate price of ANS crude

T_{VL} = transportation cost from Valdez to lower 48 refinery

T_{VK} = transportation cost from Valdez to Kenai

T_{AK} = transportation cost from alternate source to Kenai

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

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

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

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

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

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

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

or

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

This situation could readily come about if

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

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

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

AGO 545448

QUESTION 3c

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

ANSWER

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

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

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

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

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

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

AGO 545450

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

QUESTION NO. 4

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

ANSWER

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

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

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

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

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

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

AGO 545452

QUESTION 5

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

ANSWER

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

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

AGO 545453

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

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

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

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

where does the quote end?

QUESTION 7

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

ANSWER

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

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

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

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

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

TABLE 1. Demand for Petroleum Liquids[1/]

	1976	1980	1985	1987	1990	2000
Million Barrels of Crude Oil Equivalent per Year	22.7	28.5	35.2	41.1	46.9	81.2
Thousand Barrels of Crude Oil Equivalent per Day	62.2	78.1	96.4	112.1	128.5	222.5

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

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

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QUESTION 9

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

ANSWER

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

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

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

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

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

QUESTION 10

How are the entitlements regulations relevant to the ALPETCO refinery?

ANSWER

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

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

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

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

AGO 545462

STATE OF ALASKA
THE LEGISLATURE

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

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

I. Subsidies

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

A. Price Reduction

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

B. Breaking of West Coast Pricing Mechanism

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

AGO 545463

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

C. Pipeline Fill

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

D. Article 2.3

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

E. Costs to the State

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

The added administrative costs listed by Commissioner LeResche included:

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

AGO 545464

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

II. Liabilities

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

A. Performance Bench Marks

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

(1) the delays and extensions which can be granted to ALPETCO, and

(2) the fact that ALPETCO would be allowed to continue to take oil during this period, precluding the State to do anything else with its Prudhoe Bay royalty share.

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

B. Processing of Oil in Petrochemical Facility

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

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

C. "Brokering" of Oil

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

D. Size of Petrochemical Facility

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

E. Article 2.4

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

III. Other Points Which Have Been Raised

Messrs. Lipton and Tussing pointed out that--

A. The major oil and chemical companies did not bid on Prudhoe Bay royalty oil which made the sale contingent on the construction of a petrochemical facility in Alaska. Conversely, it has been pointed out that ALPETCO has limited marketing and financing capabilities.

B. The Japanese market, on which ALPETCO relies so heavily, can be supplied more advantageously from other places than Alaska, and representations by ALPETCO about Japanese interest appear inflated.

C. The project could get financing, even be on stream, and not be profitable. The likelihood that the State would let the project flounder or go under is unthinkable. Mr. Lipton

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

(1) it would be the only major project in Alaska, and

(2) if the State did not come to the aid of ALPETCO during a difficult time, it may be viewed by others as the State not seriously considering development.

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

EK:jm

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

(Enclosure)

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

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

MEMORANDUM April 5, 1978

SUBJECT: Questions regarding ALPETCO contract

TO: Elke Kallab

FROM: Randolph Berry
Revisor of Statutes

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

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

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

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

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

RB:jpd

AGO 545469

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

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

MEMORANDUM

March 27, 1978

SUBJECT: Entitlements - ALPETCO Contract

TO: The Honorable Bill Miles

FROM: Elke Kallab *Ek*
Research Analyst

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

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

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

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

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

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

answered as Question #10.

EK:jm
Attachment

cc: Marv Clement, Battelle

AGO 545470

Copy given to Ward Swift 2/16/78

Bonner & Moore Associates, Inc.

500 Jefferson | Cullen Center
Houston Texas 77002
Area Code 713 659-1871
Cable: BONMOR

February 10, 1978

RECEIVED
FEB 14 1978
Department of Natural Resources

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

Dear Commissioner LeResche:

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

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

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

AGO 545471

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

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

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

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

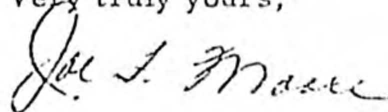
Section 4, Conclusions should be modified consequently. Our ranking, A. Economic Viability, would now list:

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

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

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

Very truly yours,



Joe F. Moore
President

JFM:mc
Attachment

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

AGO 545473

TABLE 8

ALPETCO CRUDE PRICE COMPARISONS

	BONNER & MOORE ($/B)
In-Value Price Range Excluding Field Costs	6.04 - 6.33
In-Value Price Range Including Field Costs	5.41 - 5.70
Deemed Economic Price Range	5.95 - 7.10
Deemed Economic Price Range Using Alpetco's Average Product Price of $30.33/B	7.63 - 8.78

AGO 545474

What Entitlements would accrue to ALPETCO

Now!

Under Proposed Amendments!

- 150 M b/d Petrochemical facility
  - 30 M b/d energy fuels refinery capacity for in-state use

- Interim taking of crude, roughly from 1979 through 1983 or longer.

- Products to be marketed on W. C and ~~Pacific Rim~~ Japan.

AGO 545475

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

get entitlement

Net effect ⟹ 2.07/b Jan. '78
↓
reduce the cost to a
refiner by that amt

ALPETCO – precedents that
Petrochem – treated as refinery

Entitlements accrue to refinery
not ALPETCO
⇙
indirect benefit to ALPETCO

Mart Clements 509 946-2270

AGO 545476

~~Rubovrately~~

Small refiner ~~[illegible]~~ big
100
150M b/d ⟶ 5¢/b (rough)
175M 0¢

~~[illegible]~~

AGO 545477

DOE

Entitlements Program

① Steve Mills - audit + Enforcement
202 254 3070

- March Hearing
Entitlement Hearings

② Doug McIver - ERA
Econ. Reg. adm.
adm. - Entitlements Program
202 254-8660

attorney
General Counsel
③ Margaret Dinneen
202 566-9565

Proposed amendments to
Entitlements Program Chi

State Representative
→ Written Testimony - Tom Williams
North Pole Refinery
GVEA
ARCO
Rice - Center of Environment
ALPETCO

AGO 545478

Sunday

Elke:

What can we find out about How Alpetis can/plans/may use the ~~entitlements~~ program?

B. mile

[illegible]

AGO 545479

Elke — Revised

STATE OF ALASKA
THE LEGISLATURE

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

LEGISLATIVE AFFAIRS AGENCY

M E M O R A N D U M

March 20, 1978

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

TO: Representative Bill Miles

FROM: Randolph Berry, Revisor of Statutes

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

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

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

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

AGO 545480

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

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

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

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

AGO 545481

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

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

Additional questions:

9. Article 12:

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

10. Article 2.3 and 2.4:

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

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

RB:hjd

AGO 545482

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

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

MEMORANDUM March 20, 1978

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

TO: Representative Bill Miles

FROM: Randolph Berry, Revisor of Statutes

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

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

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

√ ? I believe the contract has been signed! / wrong

AGO 545483

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

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

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

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

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

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

RB:hjd

For Randy Berry - 3/20/78

Questions raised--

By Battelle: Article 10

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

By Rep. Chat Chatterton: Article 14.3

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

AGO 545486

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

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

MEMORANDUM — March 16, 1978

SUBJECT: ALPETCO Contract - W.O. #5141

TO: Randy Berry
Staff Attorney

FROM: Elke Kallab *Ek*
Research Analyst

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

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

EK:jm

cc: Hon. Joe McKinnon
Hon. Bill Miles

AGO 545487

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

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

M E M O R A N D U M

March 14, 1978

SUBJECT: ALPETCO Contract - W.O. #5141

TO: Randy Berry
Staff Attorney

FROM: Elke Kallab *Ek*
Research Analyst

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

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

Thank you!

EK:jm

AGO 545488

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

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

March 10, 1978

MEMORANDUM

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

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

FROM: Gregg K. Erickson
Director of Research

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

1. We have had underway since December of last year a study by Battelle Northwest evaluating the U.S. and worldwide markets for Alaska royalty crude, particularly in relation to the possible sale that crude under a long term, no strings attached, contract. This study has already produced some very valuable and useful information, and will be presented in its entirety to the legislature on March 16.

2. The Institute of Social and Economic Research at the University of Alaska is doing, under contract to the agency, an economic impact analysis of the proposed ALPETCO facility. The initial output of the study will be available April 7, and additional work will continue on it until the funds allocated ($18,000) are exhausted, or the legislature acts on the contract, whichever occurs first. This study will particularly look at the population effects of the construction and operation of the ALPETCO facility, changes in personal income, overall impact on state revenues from sources other than proceeds of royalty oil sale, and related matters. This is primarily in an econometric study and will be under the supervision of Scott Goldsmith.

AGO 545489

3. In addition to the contract noted above in (1), Battelle Northwest is also addressing some specific questions which have been raised by the ALPETCO contract. A list of these questions is attached. We would be particularly interested in any additions which you might suggest. So far we have allocated $10,000 of agency funds for this project. We hope to have responses to most or all of these questions before April 15.

4. The agency's legal staff is investigating whether the procedures followed by the administration in negotiating the ALPETCO contract were in conformance with state law, and the question of whether the commitment of undeveloped and undiscovered royalty oil is consistent with the statute. We hope to have preliminary answers to these questions by March 15, and a final report by the end of the month. Attached is a list of other questions being addressed by the agency's legal staff.

5. In addition to administering the contract work under (1-3) above, the research staff is looking into the pricing provisions contained in the ALPETCO contract. Further, we have prepared, and are adding to as we go along, a list of questions that the legislature itself may wish to address.

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

GKE:dh

AGO 545490

CONTRACT BETWEEN

STATE OF ALASKA

LEGISLATIVE AFFAIRS AGENCY

AND

UNIVERSITY OF ALASKA

INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH

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

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

IT IS THEREFORE MUTUALLY AGREED THAT:

CLAUSE I. - STATEMENT OF WORK

(A) (PHASE I) - The Contractor shall prepare estimates of the economic impact of the petrochemical manufacturing facility proposed to be built by Alaska Petrochemical Company, with particular attention to changes in employment levels, personal income, state and local taxes, and population. The Contractor shall assume that the proposed facility will be sited in the vicinity of the city of Kenai. The estimates shall be conducted using the Contractor's MAP model of the Alaska economy.

(B) (PHASE II) - The Contractor shall conduct such further analysis of the benefits and costs of proposed sale of royalty hydrocarbons as the Agency may from time to time request. Requests shall be submitted in writing.

CLAUSE II. - CONTRACTOR'S STAFF

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

AGO 545491

CLAUSE III. - PERIOD OF PERFORMANCE

(A) Work under Clause I(A)(Phase I) of this contract shall be performed between 15 January 1978 and 7 April 1978. The Contractor recognizes that time is of the essence in completion of this phase of the work, and that the work product may be of no value to the Agency if delivered after 7 April 1978.

(B) Work under Clause II(B)(Phase II) shall be conducted prior to 30 June 1978. Individual tasks shall be completed by the dates specified in the written requests for such work.

(C) This contract may be terminated after 7 April 1978 by written notice of either party to the other.

CLAUSE IV. - PROJECT DIRECTOR

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

CLAUSE V. - COMPENSATION AND METHOD OF PAYMENT

(A) Contractor's compensation for the work specified in Clause I(A) shall be , payable on completion of Phase I.

(b) Contractor shall be compensated for the work done under Clause I(B) at the Contractor's published daily rates, a copy of which is attached to and made a part of this contract.

(C) Expenses incurred by the Contractor in the completion of the work set forth in Clause I(A) shall be borne by the Contractor. Expenses incurred by the Contractor in completion of the work set forth in Clause I(B) shall be reimbursable by the Agency. Costs of travel approved in advance in writing by the Project Director shall be reimbursable to the Contractor on the basis of state per diem rates and coach class air fare.

(D) Total compensation under this contract, including expenses, may not exceed $18,000.

CLAUSE VI. - IN-CASH CONTRIBUTION

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

CLAUSE VII. - RECORDS, DOCUMENTS, AUDIT

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

AGO 545492

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

CLAUSE VIII. - REPORTS

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

CLAUSE IX. - ALL WRITINGS CONTAINED HEREIN

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

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

UNIVERSITY OF ALASKA, INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH

E. LEE GORSUCH Date

LEGISLATIVE AFFAIRS AGENCY

GREGG K. ERICKSON Date

Accepted: UNIVERSITY OF ALASKA

HOWARD A. CUTLER Date
Chancellor

Approved as to form:

AGENCY LEGAL COUNSEL

Attachment

AGO 545493

Nine Questions

Priorities	Question #	
(1)	2.	2 pp.
(2)	1.	
(3)	5.	
(4)	7.	
(5)	3.	
(6)	9.	
(7)	4.	
(8) + (9)	6. and 8. will not be addressed by Battelle	

AGO 545494

LEGISLATIVE AFFAIRS AGENCY

March 8, 1978

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

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

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

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

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

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

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

   a. Under what circumstances can you envision the state offering future royalty oil for less than what ALPETCO is required to pay for Prudhoe Bay royalty oil as covered in article 2.3, [illegible] ([illegible])

   b. [illegible] Given your knowledge of Alaska's oil market's, what is your assessment of the probability that circumstances which would bring this section of the contract into effect will actually occur?

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

AGO 545495

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

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

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

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

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

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

AGO 545496

STATE OF ALASKA
THE LEGISLATURE

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

LEGISLATIVE AFFAIRS AGENCY

March 8, 1978

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

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

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

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

(More to come tomorrow.)

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

problem with ALPETCO delivering the oil

not disrupt! not able to mkt it!

AGO 545497

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

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

3(b). (Elaboration of question 3, sent yesterday). Article 2.3 of the contract gives ALPETCO an option to purchase up to 90% of any oil that is sold or offered by the state at a price lower (taking account of transportation costs) than the price paid by ALPETCO under this contract. Given your knowledge of Alaska's oil market's, what is your assessment of the probability that circumstances which would bring this section of the contract into effect will actually occur?

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

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

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

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

AGO 545498

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

End of Questions

AGO 545499

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

509-946-2718

Question for Ward Swift, Battelle

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

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

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

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

The questions are:

a. If the State can sell available royalty oil under Article 2.3 for less, up until the facility comes on stream, then why should it be tied to the effective date?

b. Since ALPETCO cannot receive Prudhoe Bay royalty oil until 18 months after the effective date of the contract at the earliest (2.2), why should the option of being able to take up to 90% of other royalty oil which is priced lower than Prudhoe Bay royalty oil be available to ALPETCO on the effective date of the contract?

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

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

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

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

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

AGO 545502

5. 10.2 - Need clarification of headings 10.2(2) through 10.2(9) as they relate to the extensions granted under them individually. (Maybe a provision for maximum amount of time for all extensions and delays [site selection] would solve the problem, although the Legislature will not be able to make that change.)

6. 4.2.2 - Is it necessary to reflect the cancellation option available to ALPETCO after two site disapprovals in 4.2.2?

7. 15.2(vii) (viii) These two force majeure clauses seem to be too loose and all inclusive. Do they need to be modified to protect the State's best interests? How about any of the other force majeure clauses?

8. Under what terms, if any, can the contract as presented to the Legislature be modified?

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

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

AGO 545503

M E M O R A N D U M

March 10, 1978

SUBJECT: ALPETCO Contract - W.O. #5141

TO: Randy Berry

FROM: Elke Kallab

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

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

Thank you!

EK:jm

AGO 545504

3/9/78

Other Issues Which Require Attention:

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

answered ACS 500-1,000,000

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

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

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

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

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

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

answered

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

AGO 545505

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

7. Final process configuration and production rates of the products to be produced at the facility will be determined by marketing considerations based on sales contracts for the products. What implication does this have for the final projected facility as currently proposed by ALPETCO? (See 6 above.)

8. Article 10.2 deals with a time-frame ALPETCO has to follow and allows for extensions under the various bench-mark dates. No provision is made in 10.2 for additional delays which may be caused by site disapprovals by the State, and resubmissions of proposed site locations by ALPETCO (4.2.2).

9. Is the security interest under Article 12 and 10.2 sufficient to protect the State's best interests, or should other requirements be added to assure successful completion and implementation of the project, such as performance bonds or liquidated damages?

3/9/78

Environmental Questions and Answers

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

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

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

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

   Will an EIS be required?

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

3. *Exhibit "D"*

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

   JERRY REINWAND: Totally satisfied with Exhibit "D".

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

AGO 545507

M E M O R A N D U M

TO: Representative Bill Miles

FROM: Lisa Nelson, Administrative Assistant

DATE: June 1, 1978

RE: Statements on taking oil in-kind and in-value

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

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

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

So, mechanically it doesn't work.

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

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

Discussion was as follows:

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

Boness: That's right.

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

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

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

Boness: We go back to taking in-value.

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

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

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

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

Chatterton: I think you are.

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

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

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

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

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

OUTLINE OF ALPETCO'S PRESENTATION

OWNERSHIP

BENEFITS TO THE STATE OF ALASKA

VIABILITY OF PROJECT

SUMMARY

MARCH 13-14, 1978

AGO 545386

OWNERSHIP OF ALPETCO

8.5% The Aleut Corporation
8.5% Bristol Bay Native Corporation
8.5% Calista Corporation
8.5% Chugach Natives, Inc.
8.5% Cook Inlet Regional Corporation
8.5% Koniag Regional Native Corporation
51.0%

49.0% Seatrain Lines, Inc. (NYSE)
- Shipbuilding
- Container Transport
- Ship Charter
- Port Management
- Oil Refining

Transmission-distribution of natural gas in Alaska since 1959

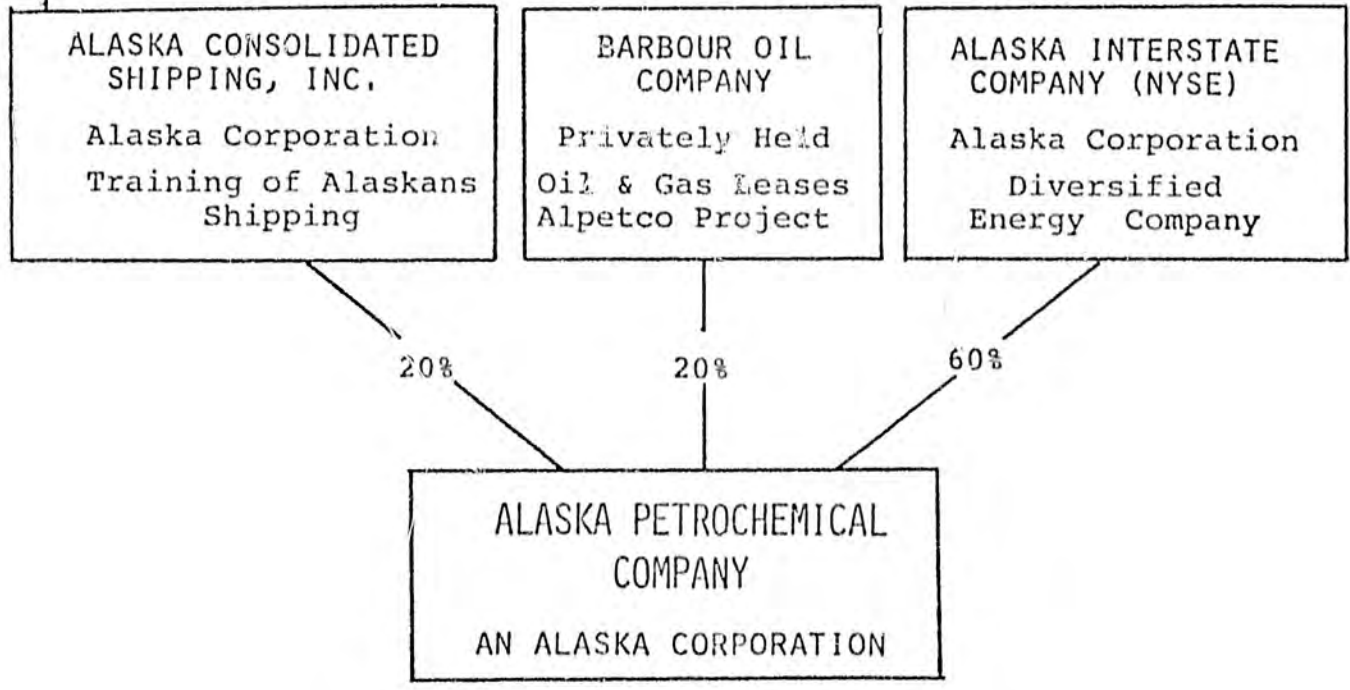
Exploration, production and liquifaction of natural gas in Indonesia (for export to Japan)

Exploration and production of oil and natural gas in the U.S.

Engineering and construction of gas processing facilities

Pollution control and sulfur recovery processes

Manufacturing



AGO 545387

BENEFITS TO THE STATE OF ALASKA

NO RISK; NO SUBSIDY

ADDITIONAL EMPLOYMENT

ADDITIONAL TAXES

ALASKA ENDOWMENT TRUST

SHIPPING CAPABILITY

SPECIALIZED TRAINING

LOCAL HIRE

CONTROLLED INDUSTRIAL DEVELOPMENT

AGO 545388

NO RISK TO THE STATE OF ALASKA

NO SUBSIDY

- NO PRICE CONCESSSION
- PORT, DOCKS, UTILITIES ARE INCLUDED IN ALPETCO'S CAPITAL REQUIREMENT ESTIMATES

NO INTERIM TAKE OF CRUDE

- UNLESS & UNTIL OBTAIN COMMITMENT FOR PERMANENT FINANCING
- WE HAVE OBTAINED DEPT. OF ENERGY FAVORABLE OPINION

PERFORMANCE BENCHMARKS

NO RISK TO ALASKA: PERFORMANCE BENCHMARKS

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

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

AGO 545390

OTHER MAJOR CONTRACT TERMS

SINCE ALPETCO'S ECONOMICS, PLANNING & FINANCING ARE BASED ON USING 150,000 BBLS/DAY,

ALPETCO WILL PURCHASE ROYALTY CRUDE UP TO 150,000 BBLS/DAY, FROM:

- 85% OF PRUDHOE ROYALTY OIL
- UP TO 70% OF OTHER ROYALTY CRUDE
  BUT ONLY IF NEEDED TO MAKE UP ANY SHORTFALL FROM PRUDHOE
  (THIS "MAKE UP" OIL IS AVAILABLE ONLY TO BRING BACK UP TO 150,000 LEVEL)

SAME "IN VALUE" PRICE, PLUS REIMBURSEMENT OF ANY COSTS STATE INCURS BY TAKING "IN KIND"

PUBLIC REFERENDUM REQURIED TO REDUCE PRICE TO BE PAID FOR ROYALTY OIL

POINT OF DELIVERY: PUMP STATION NO. 1
(STATE IS NOT A SHIPPER)

FUELS FOR IN-STATE USE OF 30,000 BBLS/DAY

ENVIRONMENTAL:

COMPLIANCE WITH FEDERAL AND STATE RULES AND REGULATIONS
INCLUDING SUPPLEMENTAL STATE STANDARDS,
WHETHER OR NOT REQUIRED BY LAW

EMPLOYMENT

PRELIMINARY PLANNING ESTIMATE
FOR ALPETCO

	MINIMUM	MAXIMUM
REFINERY (CONVERSION UNITS, UTILITIES, MARINE)	450	550
AROMATICS UNITS	250	300
OLEFINS STEAM CRACKER	300	375
POLYETHYLENE UNITS	400	575
POLYPROPYLENE UNITS	250	350
GENERAL WORKS MANAGEMENT	75	75
AVERAGE CONTRACT HELP	200	250
TOTAL JOBS	1,925	2,475

INCLUDED IN THE ABOVE TOTALS ARE 800 TO 950 MAINTENANCE JOBS

AGO 545392

SUMMARY OF ADDITIONAL EMPLOYMENT

NEW JOBS:

CONSTRUCTION PHASE (3 1/2 YEARS)	3,500 - 4,000	
OPERATIONS PHASE (20 YEARS)		
PETROCHEMICAL FACILITY	1,900	2,500
SHIPPING (ACS)	250	350
TOTAL PERMANENT JOBS	2,150	2,850

A SUBSTANTIAL NUMBER OF ADDITIONAL JOBS AND ADDITIONAL BUSINESS OPPORTUNITIES WILL BE CREATED AS SUPPORT FOR THIS COMPLEX.

AGO 545393

DIRECT TAX BENEFITS TO ALASKA*

$2.5 Billion Tax Base

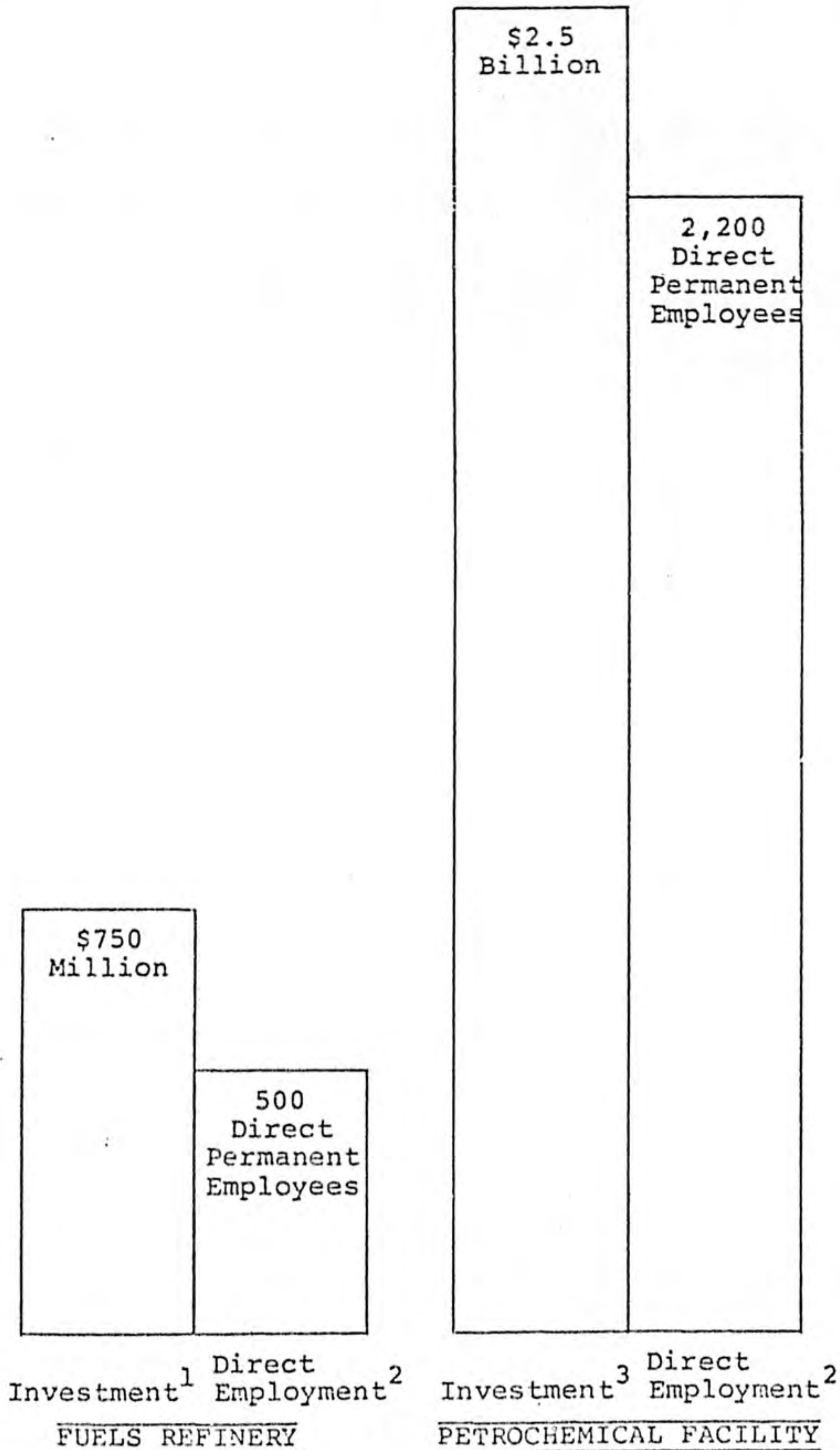
	($ Millions)	
	------- Estimated** ---------	
	Average Per Year	Total Contract Period
Property Taxes (@ 1%)	$ 23	$ 612
State Corporate Income Tax	23	632
Gross Receipts Tax	3	90
	$ 49	$1,334

*Does not include estimates of personal income taxes paid by Alpetco employees or any taxes paid by support businesses or employees of support businesses

**Source: March 10, 1978 analysis for The Institute of Social and Economic Research

AGO 545394

COMPARISON OF INVESTMENT (TAX BASE)
AND DIRECT EMPLOYMENT
TYPICAL FUELS REFINERY VS. PETROCHEMICAL FACILITY



Source: [1] Alpetco Estimate
[2] Chem Systems Inc.
[3] Alpetco Proposal

AGO 545395

ALASKA ENDOWMENT TRUST
(A CHARITABLE FOUNDATION)

PURPOSE — TO FURTHER THE

SOCIAL — CULTURAL

EDUCATIONAL — ENVIRONMENTAL

CONDITIONS IN THE STATE OF ALASKA

CONTRIBUTIONS BY ALPETCO

5% OF NET AFTER-TAX PROFITS EACH YEAR BEGINNING 10 YEARS AFTER START-UP

ESTIMATED CONTRIBUTION:

AVERAGE PER YEAR	$10 MILLION
IN TEN YEARS	$100 MILLION

ADMINISTRATION OF THE TRUST

INDEPENDENT BOARD OF TRUSTEES

UNAFFILIATED WITH ALPETCO

APPOINTED BY THE GOVERNOR

CONFIRMED BY THE LEGISLATURE

AGO 545396

SHIPPING CAPABILITY

ALASKA CONSOLIDATED SHIPPING IS ALPETCO'S SHIPPING ARM

WILL PROVIDE SPECIALIZED SHIPS FOR PRODUCTS MANUFACTURED

PROVIDES CAREER OPPORTUNITIES FOR ALASKAN CITIZENS IN MARITIME INDUSTRY

EXPERIENCED MANAGEMENT IN

SHIPBUILDING
SHIP CHARTER
PORT OPERATIONS MANAGEMENT

MAJORITY OF ACS IS OWNED BY SIX ALASKA REGIONAL NATIVE CORPORATIONS

BACKED UP BY SEATRAIN LINES, ONE OF THE LARGEST SHIPPING COMPANIES IN U.S.

AGO 545397

SPECIALIZED TRAINING
FOR ALASKANS

ALREADY HAPPENING

SHIPPING:

HARRY LUNDEBERG SCHOOL
SEAFARER'S INTERNATIONAL UNION
PINEY POINT, MARYLAND

REFINERY:

PRIDE OIL REFINERY
SEATRAIN LINES, INC.
ABILENE, TEXAS

PLANNED

EXTENSIVE TRAINING PROGRAMS FOR ALASKANS IN:

ALL PHASES OF SHIPPING
PLANT OPERATION
PLANT MAINTENANCE

COORDINATED WITH BROWN & ROOT, CHEM SYSTEMS, ALASKA STATE OFFICIALS AND LABOR UNION OFFICIALS

AGO 545398

LABOR POLICIES

ALASKA CONSTRUCTORS, INC.

LOCAL HIRE

TOTAL PROJECT EMPLOYMENT

- CONSTRUCTION, START-UP, OPERATIONS
- PHASING INTO PERMANENT JOBS
  - MAINTENANCE
  - OPERATIONS

AGO 545399

CONTROLLED INDUSTRIAL DEVELOPMENT

CLEAN INDUSTRY

ENVIRONMENTALLY SAFE

HIGH CAPITAL INVESTMENT PER EMPLOYEE

ATTRACTS SIMILAR DESIRABLE INDUSTRY

AGO 545400

The Anchorage Times, Sunday, February 19, 1978

Royalty Oil Decision

By Robert R. Richards

THIS WEEK the administration is to deliver to the Legislature its recommendation regarding disposition of the state's royalty oil.

Although several experts have questioned the viability of the four proposals before the Royalty Oil and Gas Development Board, it should be noted that the four bidders have been working closely with the state over the past few months to develop plans that make sense for all parties. Now consultants Bonner and Moore Associates Inc. have concluded that at least three of the four contenders are "fully qualified."

It seems to me that anyone concerned about the stability and long run health of Alaska's economy should give careful consideration to this marvelous opportunity to expand the vertical integration of Alaska's industrial base. Our woefull lack of in-state processing of our resources has contributed to chronic abnormal fluctuations in Alaska's economy. Expanding the manufacturing operations in Alaska will help create a more stable and therefore more socially healthy economy in Alaska.

Additionally, the petrochemical industry brings substantial benefits far beyond those of many other industries. It is highly capital intensive and one of the lowest labor intensive industry of any of our nation's basic industries. Therefore, expansion by the petrochemical industry results in very little population impact. The highly automated petrochemical operation requires very few workers and therefore imposes very little additional burden on public services, such as schools, hospitals, highways, etc.

SO IT IS very clear to see that the petrochemical industry, relative to other potential industries, imposes a very small social cost. But what about the other side of the coin? What does this industry do in the way of creating social benefits?

Again, in this regard the petrochemical industry is a star performer. Its first sociall benefit results from its employing highly skilled, well educated, and high paid employees. These people generally have a high participation rate in community affairs. Their high incomes are taxed commensurately high, and their socio-economic station in life geneally implies fewer social problems in the sense of crime, disease and the like.

The second social benefit emanating from the petrochemical industry is its contribution to creating a more stable economy. The industry is virtually non-seasonal. As we all know, those plants down on the Kenai Peninsula keep producing 365 days out of the year. Alaska's other basic industries, fishing, forest products and tourism, are highly seasonal industries. As a result typically employment in Alaska in January is one-fourth below the level of employment in July. Such seasonality creates all sorts of problems. The expansion of the petrochemical industry in Alaska will help considerably to reduce the overall seasonality of employment in our state.

ANOTHER WAY in which industry employment varies is the swings from year to year. This phenomenon, of course, is referred to as the business cycle. Again, Alaska's fishing and forest products industries are highly cyclical industries. The petrochemical industry, on the other hand, experiences considerably less cyclical fluctuation.

Therefore, the expansion of the petrochemical industry in Alaska would reduce both the seasonal and cyclical fluctuations in our economy, bringing about a considerably more stable employment situation.

The third major social benefit from the petrochemical industry results from the huge taxes and other forms of government revenue generated from this industry. The key factor here is that revenue flowing to both state and local government exceeds by far the additional burden which the industry and its employees place on state and local government. So there are all sorts of excess funds available for the pursuit of a whole array of social objectives: parks, bike paths, better schools, better health care, and on, and on and on.

This then, is what leads me to a very important conclusion which we should keep clearly in mind. It is simply this: because of the huge public revenue generated by the petroleum and petrochemical industries this type of economic growth is not only compatible with, but indeed is conducive to the pursuit of the whole array of our non-economic objectives.

Perhaps I can summarize by acknowledging the general positive relationship between our "quality of life" objectives and our economic development. Here we have the opportunity to encourage an industry which will bring wages, highly skilled, well educated people to stable employment and which manyfold more than pays it own way in terms of social impact. The social and economic attractiveness of the petrochemical industry is self-evident.

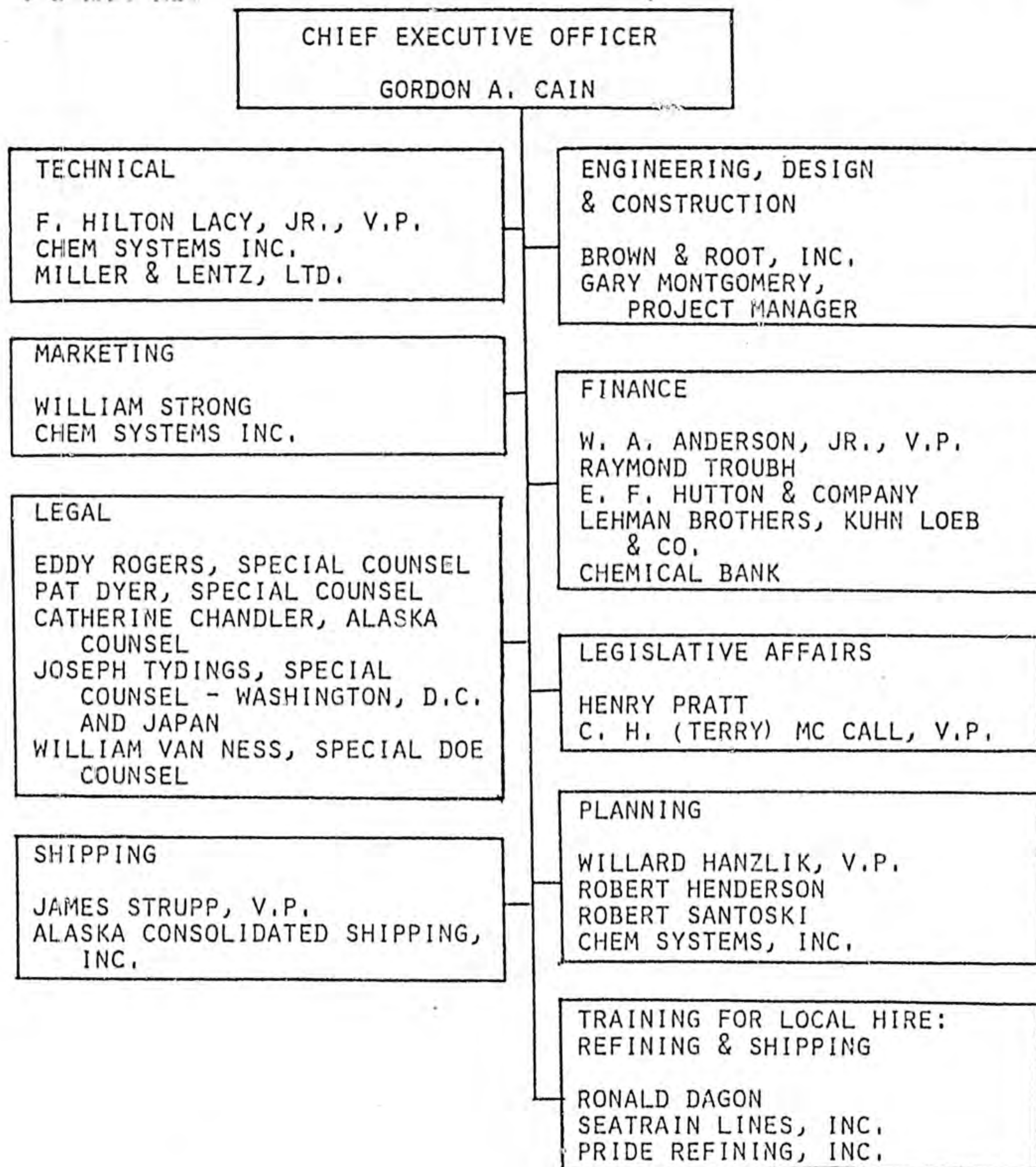
Robert R. Richards, an economist, is executive vice president of Alaska Pacific Bank.

AGO 545401

ORGANIZATION AND MANAGEMENT - DEVELOPMENT PHASE

BOARD OF DIRECTORS

O. CHARLES HONIG - CHAIRMAN
GORDON A. CAIN
W. A. ANDERSON
JOHN GUNDERSEN
WILLARD M. HANZLIK
F. HILTON LACY
SAM C. OLIPHANT
C. H. MC CALL
JAMES J. STRUPP



AGO 545402

CHIEF EXECUTIVE

GORDON A. CAIN

EXPERIENCE

OVER 30 YEARS IN PETROCHEMICAL INDUSTRY

RESPONSIBLE FOR

PROMOTION STAFFING

FORMATION MANAGEMENT

MARKET DEVELOPMENT OF
MAJOR PETROCHEMICAL FACILITIES IN

UNITED STATES EUROPE
JAPAN SOUTH AMERICA

CURRENT POSITIONS

PRESIDENT (AND ONE OF ORGANIZERS)

PETRO-TEX CHEMICAL CORPORATION

HOUSTON

BOARD CHAIRMAN (AND ORGANIZER)

PETROQUIMICA ARGENTINA, S.A.

BUENOS AIRES

AGO 545403

CHEM SYSTEMS INC.

LEADING INTERNATIONAL FIRM SPECIALIZING IN MARKETING AND TECHNICAL SUPPORT OF THE PETROCHEMICAL INDUSTRY

OFFICES

NEW YORK	LONDON	MUNICH
HOUSTON	PARIS	SAO PAULO
BEIRUT		

STAFF OF 80 PROFESSIONALS

CLIENTS INCLUDE MOST OF THE WORLD'S LEADING OIL AND CHEMICAL COMPANIES, AS WELL AS SEVERAL NATIONAL GOVERNMENTS

EXPERIENCED IN PETROCHEMICAL PROJECT DEVELOPMENT WORLD WIDE, INCLUDING

UNITED STATES	JAPAN
WESTERN EUROPE	MIDDLE EAST

EXPERTS ON SUPPLY-DEMAND AND ECONOMICS OF PETROCHEMICALS

- UNITED STATES
- WORLD WIDE

BROWN & ROOT, INC.

OFFICES: HOUSTON AND MAJOR CITIES WORLD WIDE

ONE OF THE LARGEST AND MOST DIVERSIFIED ENGINEERING AND CONSTRUCTION COMPANIES IN THE WORLD

LARGEST VOLUME OF ANY U.S. CONSTRUCTION COMPANY LAST YEAR

SUBSIDARY OF HALLIBURTON COMPANY

1976 REVENUES = $4.9 BILLION

SHAREHOLDERS EQUITY (12-31-76) = $1.4 BILLION

EXPERIENCED IN ALASKA

NORTH SLOPE PRODUCTION FACILITY FOR B.P.

JOINT VENTURE ON 2 NORTHERN SEGMENTS OF ALYESKA PIPELINE

INDUSTRIAL COMPLEX FOR BIG-3 INDUSTRIES

EXPERIENCED IN DESIGN, ENGINEERING, CONSTRUCTION

REFINING

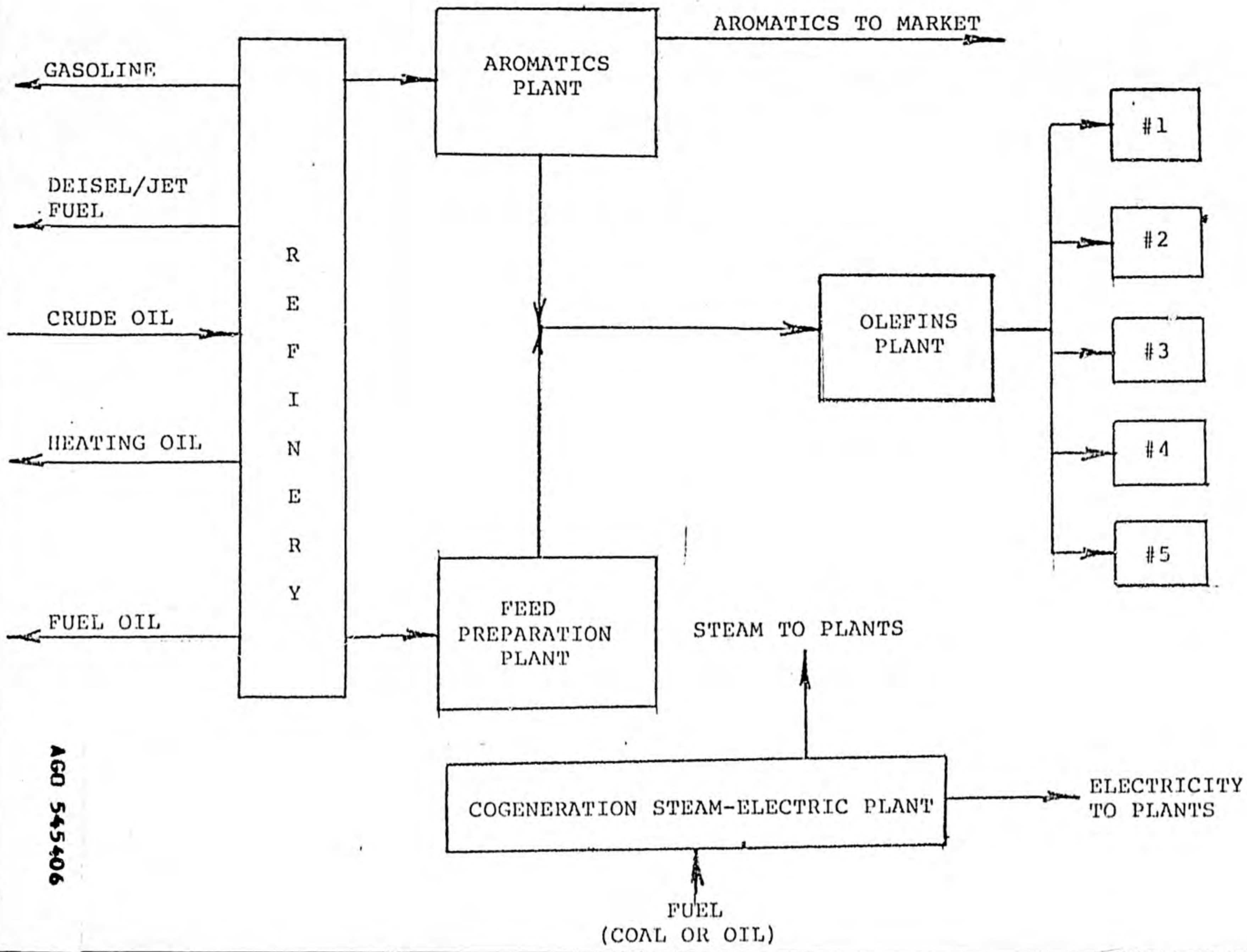
PETROCHEMICAL FACILITIES

OFFSITES

WORKS IN ALASKA THROUGH ALASKA CONSTRUCTORS, INC., A UNION SHOP

AGO 545405

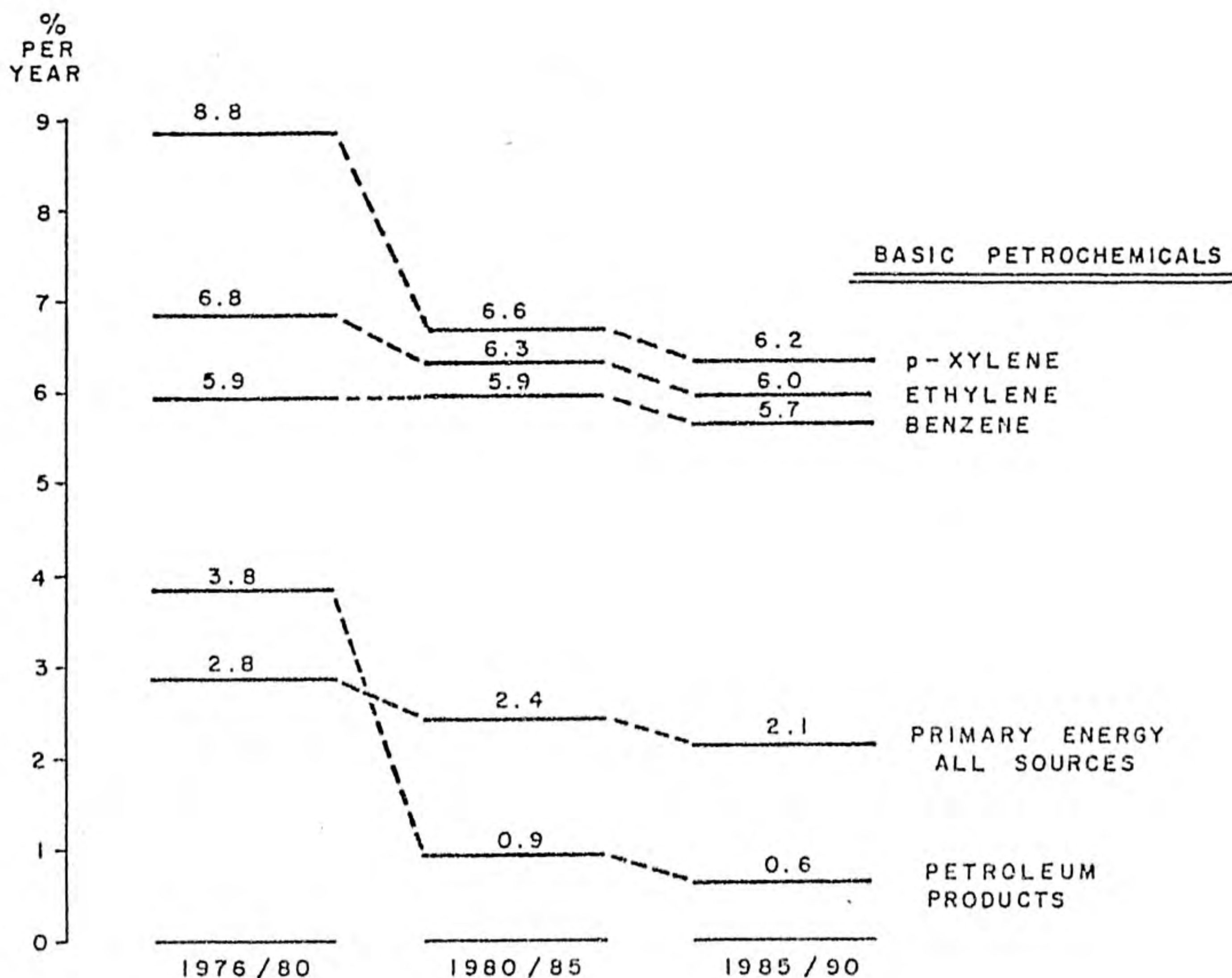
ALPETCO PROJECT



AGO 545406

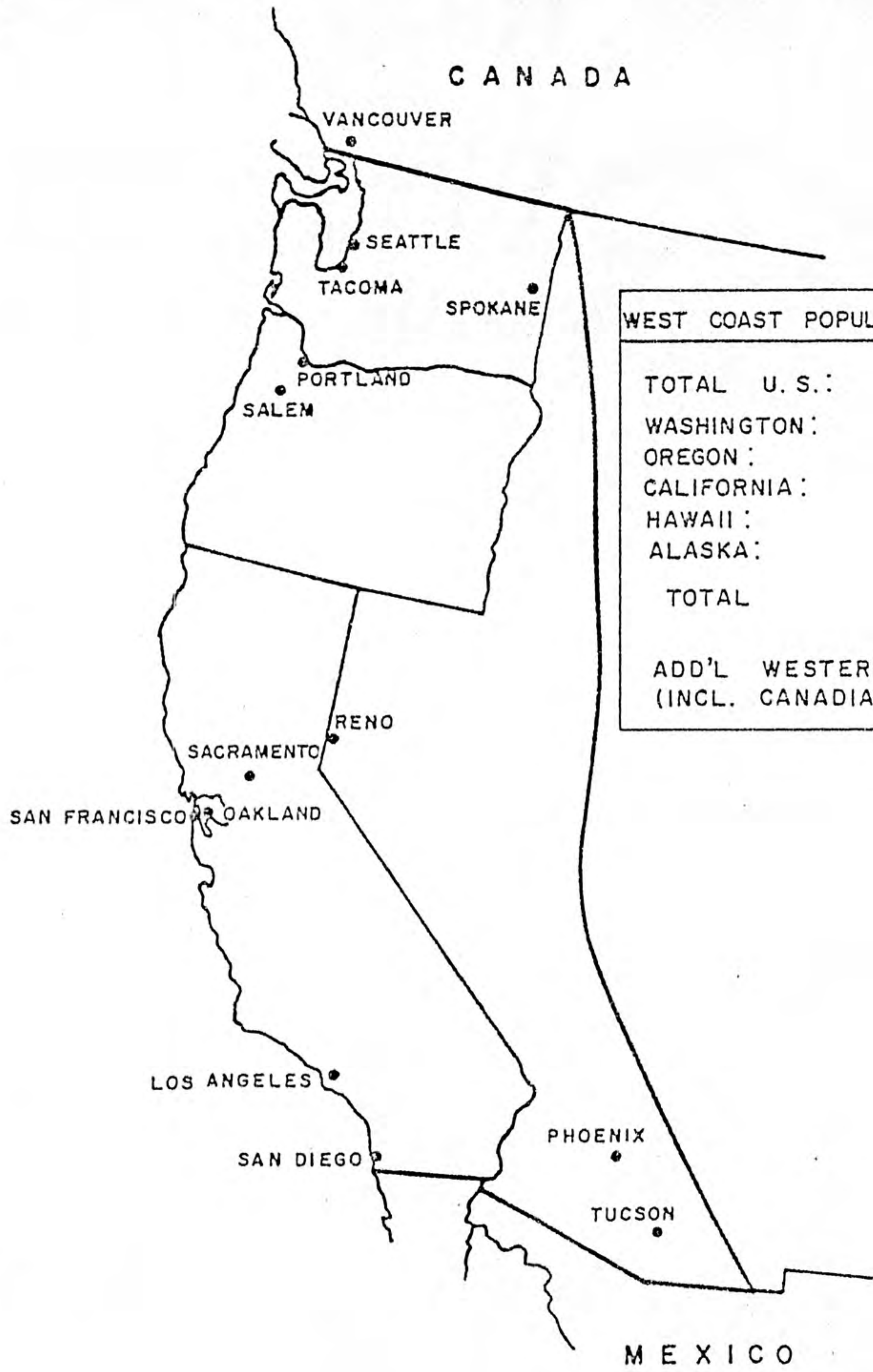
FORECAST GROWTH RATES

PETROCHEMICALS VS. FUELS PRODUCTS



CHEM SYSTEMS INC.
PROJECT NO. DATE

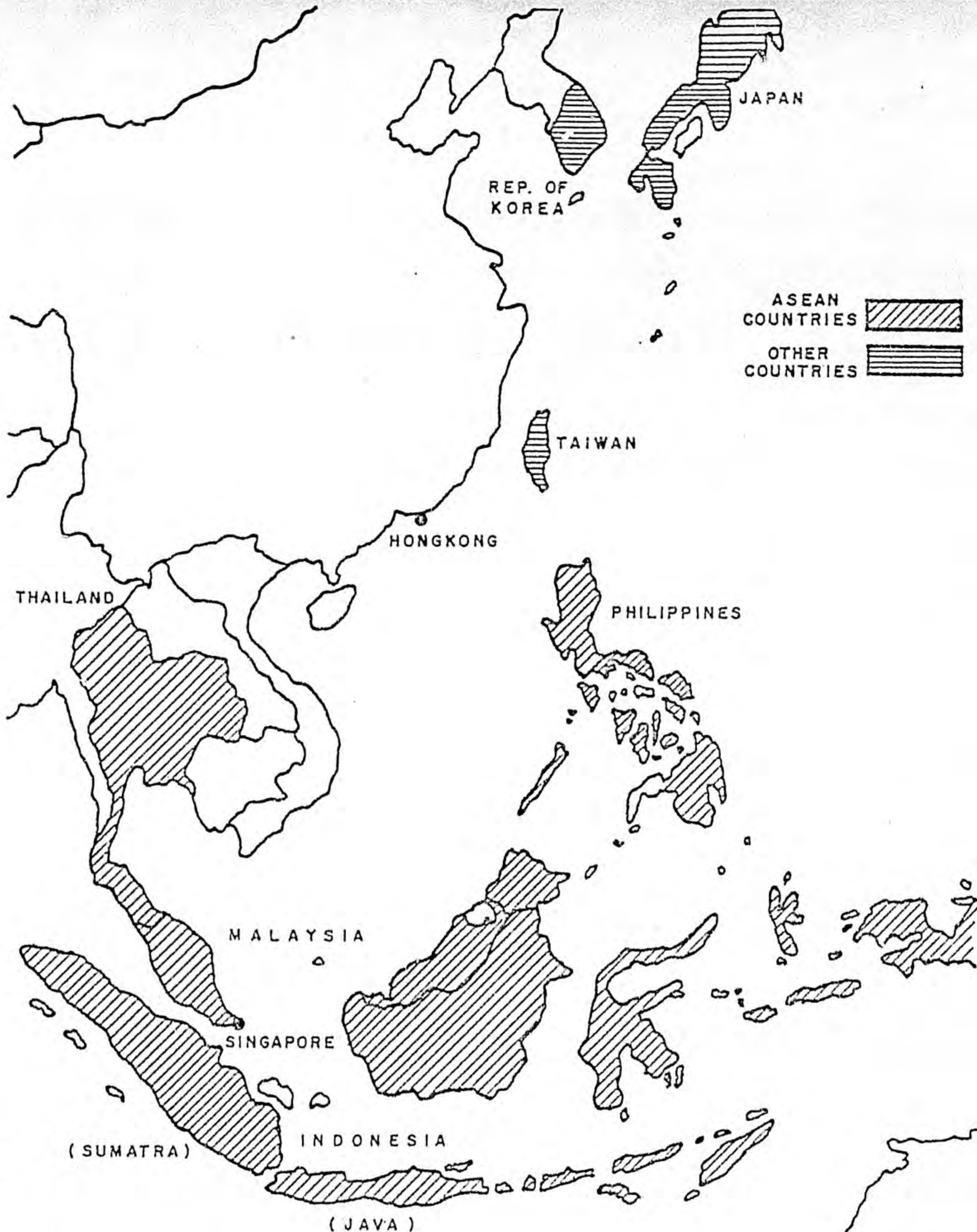
AGO 545407



WEST COAST POPULATION BREAKDOWN	
TOTAL U.S.:	213 MM
WASHINGTON:	3.5 MM
OREGON:	2.3 MM
CALIFORNIA:	21.2 MM
HAWAII:	0.9 MM
ALASKA:	0.4 MM
TOTAL	28.3

ADD'L WESTERN MARKETS (INCL. CANADIAN): 5 MM

PACIFIC BASIN COUNTRIES



CHEM SYSTEMS INC.

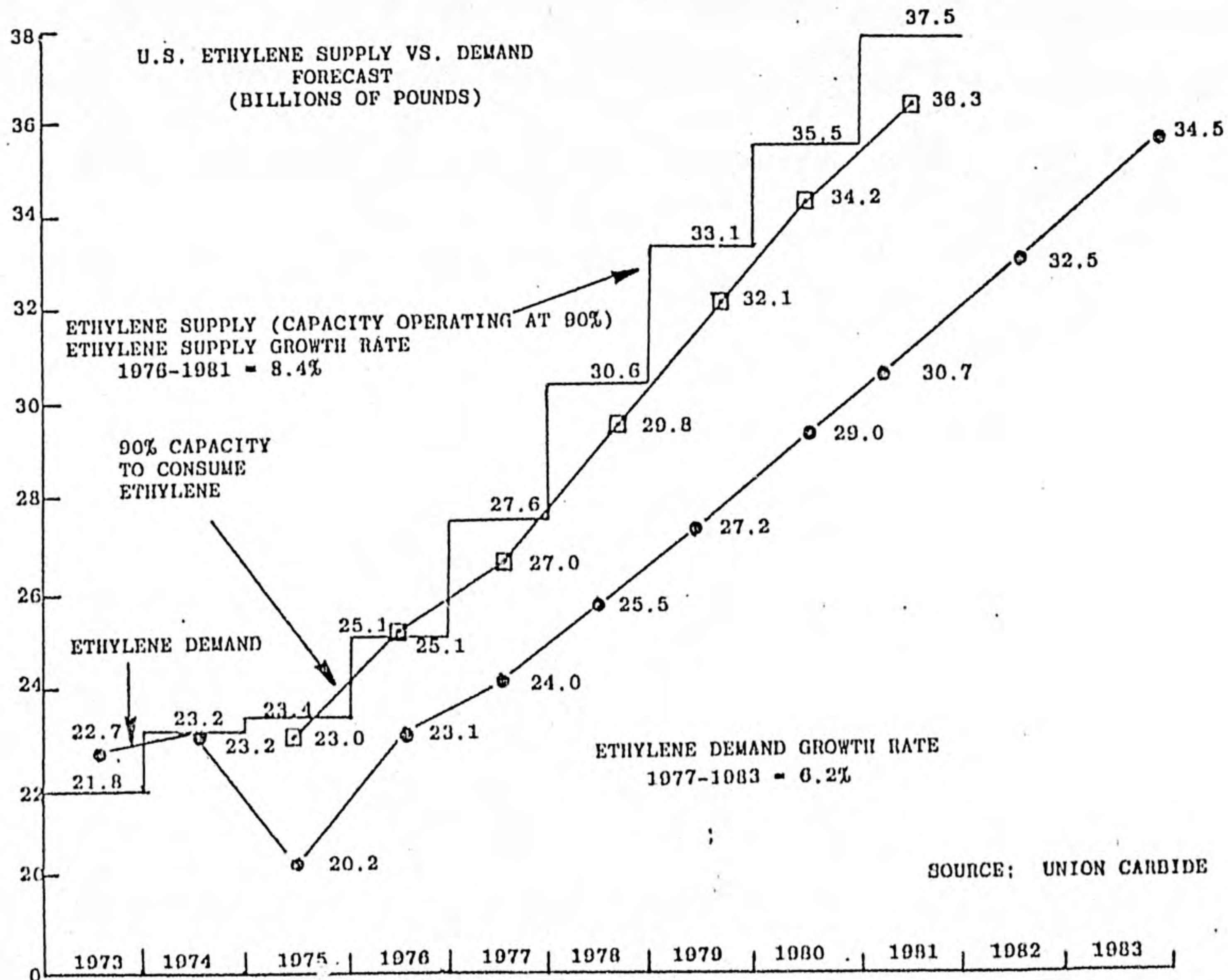
PROJECT NO. DATE

FORECAST OF U.S. DEMAND FOR BASIC PETROCHEMICALS

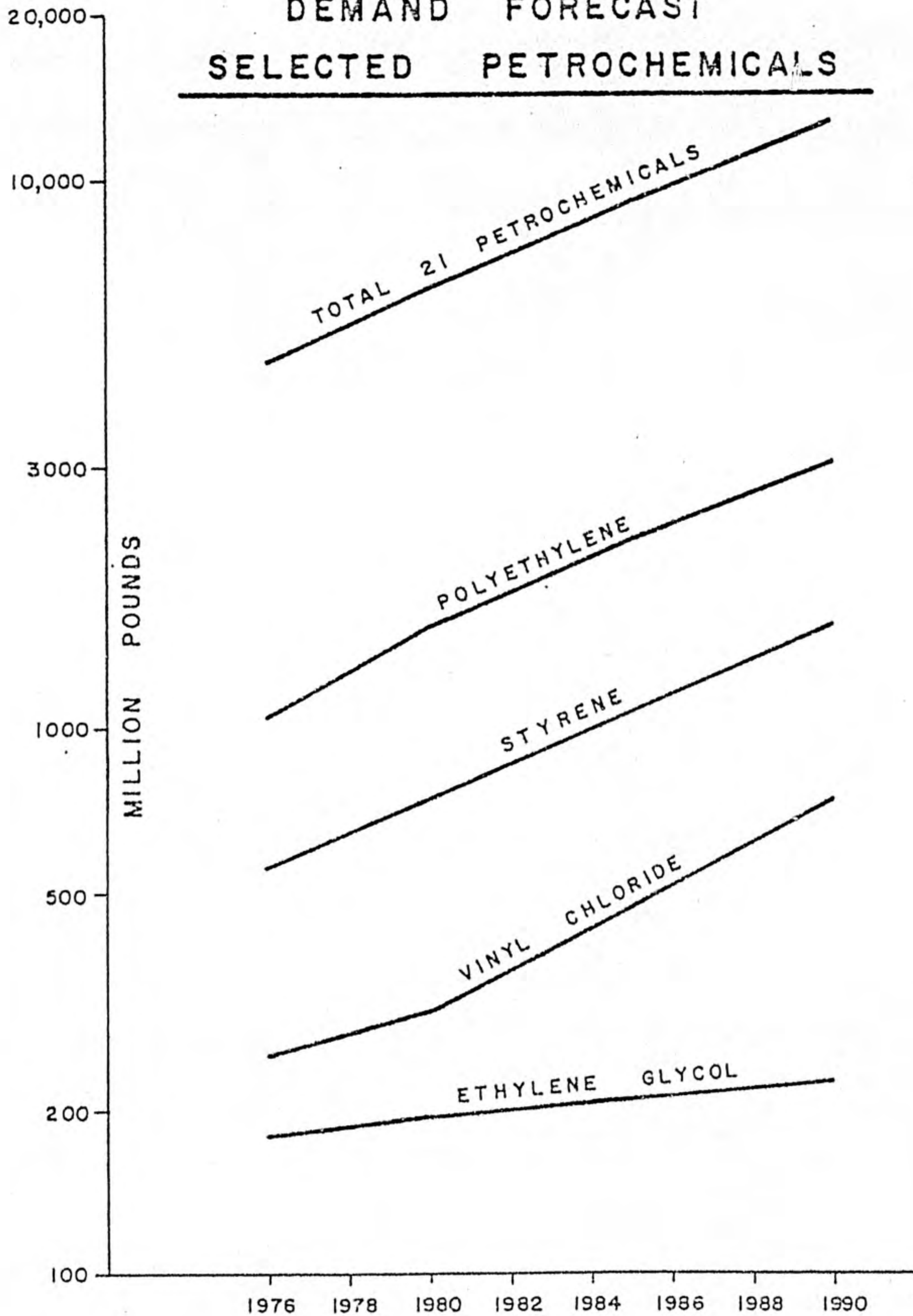
(BILLION POUNDS PER YEAR)

YEAR	ETHYLENE	PROPYLENE	BENZENE
1980	31	15	13
1990	53	28	21
2000	85	47	33
ALPETCO (CASE LE-1)	1.2	0.7	1.0

AGO 545410



AGO 545411



AGO 545412

CHEM SYSTEMS INC.
PROJECT NO. DATE

U.S. WEST COAST
SUPPLY-DEMAND
SELECTED PETROCHEMICALS

	Million Pounds			
	1976	1980	1985	1990
Ethylene for Major Derivatives				
Supply (1)	250	250	250	250
Demand	1725	2435	3455	4500
Low Density Polyethylene				
Supply (1)	120	120	120	120
Demand	710	1000	1400	1900
Styrene				
Supply (1)	0	0	0	0
Demand	555	742	1085	1590

Note:
(1) Currently installed capacity only

PACIFIC BASIN COUNTRIES
FORECAST IMPORT DEMAND
1985
SELECTED PETROCHEMICALS

19 PETROCHEMICALS
5 BILLION POUNDS

POLYETHYLENE 1.4
POLYPROPYLENE 0.45
ETHYLENE GLYCOL 0.4
p-XYLENE 0.5
STYRENE (OR E/B)
OTHERS

AGO 545414

NEW WORLD SCALE ETHYLENE PLANTS NEEDED

	U.S. WEST COAST	OTHER PACIFIC BASIN
1976-85	3	2
1985-90	1	4
	4	6

ALPETCO INITIALLY PLANS ONE WORLD SCALE PLANT

AGO 545415

OPPORTUNITIES TO BUILD NEW PETROCHEMICAL DERIVATIVE PLANTS (WORLD SCALE SIZE)

	For Supply To		
	U.S. West Coast	Pacific Basin Areas (Includ. Japan)	Other Markets
Low Density Polyethylene	X	X	
High Density Polyethylene	X	X	
Polypropylene		X	
Ethylene Glycol		X	
Styrene	X		
- Ethylbenzene		X	
Cumene	X		X
Paraxylene		X	
Aromatics Benzene, Toluene, Xylenes	X	X	X

AGO 545416

ALPETCO PROJECT (CASE LE-1)

CRUDE OIL REFINERY:

FUEL PRODUCTS: ALASKA (30,000 B/D) FUEL OILS

CHEMICAL FEEDSTOCKS: NAPHTHA, GAS OIL

PRIMARY PETROCHEMICAL FACILITIES:

AROMATICS PLANT: BENZENE, TOLUENE, XYLENE
(4% OF U.S. PLUS PACIFIC BASIN REQUIREMENTS IN 1985)

OLEFINS PLANT: ETHYLENE, PROPYLENE, BUTADIENE
(3% IN 1985)

TYPICAL DOWNSTREAM FACILITIES

PRODUCT	NORMAL MODERN PLANT SIZE	ALPETCO OUTPUT IN 1985
LOW DENSITY POLYETHYLENE	600 MM LBS/YR	4%
HIGH DENSITY POLYETHYLENE	300 MM LBS/YR	3%
POLYPROPYLENE	400 MM LBS/YR	4%
STYRENE	800 MM LBS/YR	6%

AGO 545417

VIABILITY OF PROJECT

MANAGEMENT

DESCRIPTION AND SCOPE

MARKETING

FINANCING

AGO 545418

MARKETING:

STRATEGIC AND POLITICAL ASPECTS

JAPAN

U.S. - WASHINGTON, D.C.

VIABILITY OF PROJECT

MANAGEMENT

DESCRIPTION AND SCOPE

MARKETING

FINANCING

AGO 545420

FINANCIAL ASPECTS

PERMANENT FINANCING

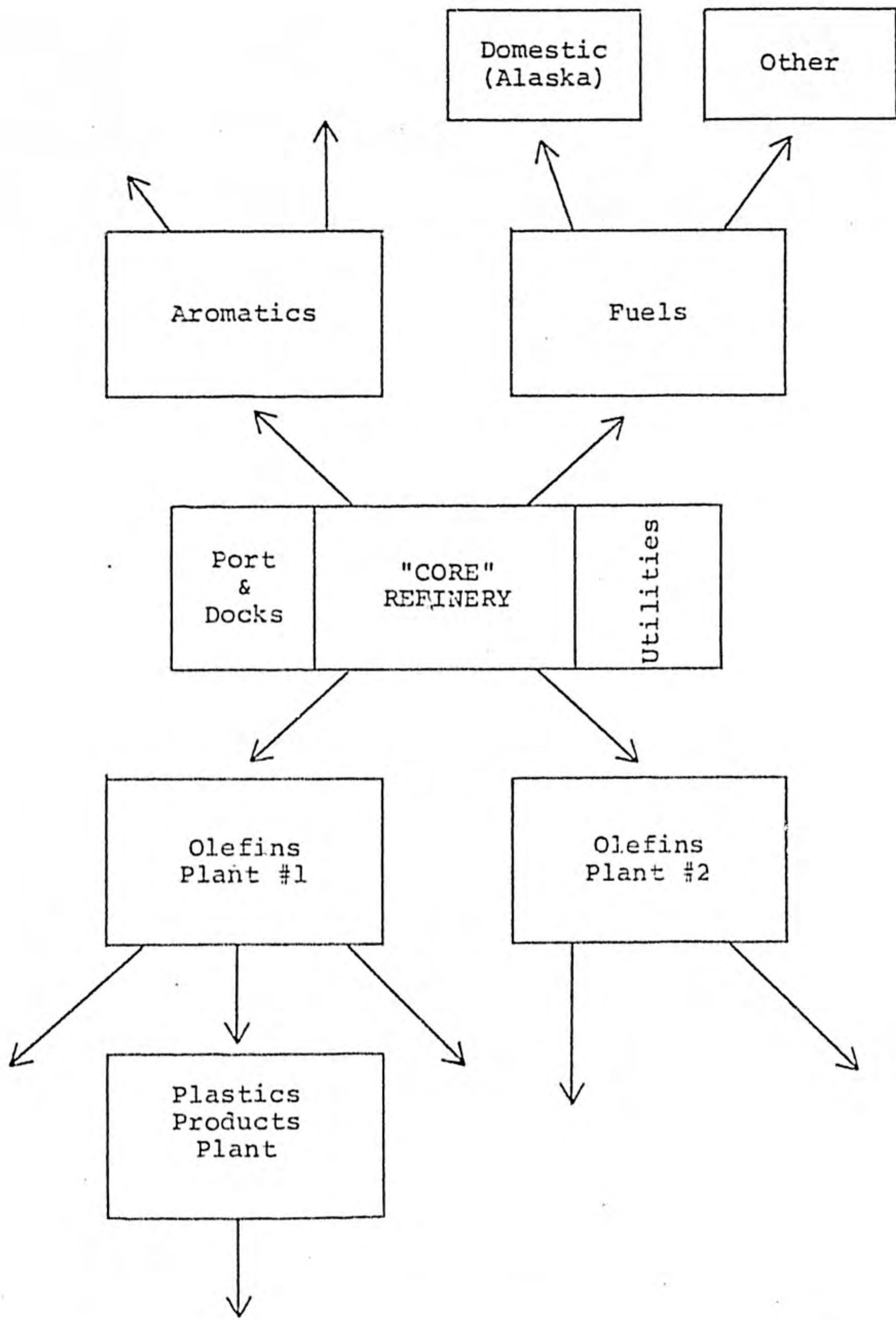
- CONVENTIONAL
- TAX EXEMPT

EQUITY

INTERIM (CONSTRUCTION) FINANCING

JOINT VENTURES

EXAMPLE OF JOINT VENTURES



IN SUMMARY. . .

HIGH PROBABILITY OF SUCCESS

ALPETCO WILL HAVE CERTAIN VALUABLE ASSETS

A LONG TERM SOURCE OF CRUDE OIL AT THE MARKET PRICE FROM A POLITICALLY STABLE REGION

A PLAN TO PRODUCE PETROCHEMICALS FOR WHICH:

THE MARKET OUTLOOK IS GOOD

THE TIMING IS GOOD

THE PLANT LOCATION HAS NO GREATER NET DISADVANTAGES THAN THE OTHER LOGICAL LOCATIONS

ALPETCO PLANS TO CAPITALIZE ON THESE ASSETS BY ASSOCIATING ONE OR MORE PARTNERS WHO WILL BRING MONEY, PRODUCT OFF-TAKE AGREEMENTS, TECHNOLOGY AND PEOPLE TO THE PROJECT

SEVERAL MAJOR U.S. AND INTERNATIONAL CHEMICAL COMPANIES HAVE EXPRESSED AN INTEREST IN PARTICIPATING IN ALPETCO

AGO 545423

ALPETCO HAS MET THE CONTRACTUAL RECOMMENDATIONS OF THE STATE ENERGY POLICY COMMITTEE

1. CANCELLATION OR TERMINATION PROVISIONS
2. LOCAL TRAINING AND HIRE
3. COMPLETION OF REFINERY TIED TO SALE OF CRUDE
4. "IN-VALUE" PRICE
5. COMPLIANCE AND SECURITY PROVISIONS
6. POINT OF DELIVERY/ZERO SHIPPING LIABILITY
7. NO SUBSIDY
8. METHOD OF PAYMENT SHOULD MINIMIZE "FLOAT"
9. IN-STATE USE OF FUELS
10. IN-STATE PROCESSING REQUIRED
11. QUANTITY NOT GUARANTEED BY STATE

AGO 545424

PETRO MARKETING SERVICES, INC.

TESTIMONY BY EARL JOHNSON

BEFORE THE

SENATE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

STATE OF ALASKA

May 11, 1978

P.O. BOX 7343 • TULSA, OKLAHOMA 74105 • (918) 747-5341 AGO 545425

Senators.

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

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

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

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

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

AGO 545426

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

Absent some strategy for the use of royalty oil prior to plant completion that I have failed to consider, there appear only two ways in which Alpetco could benefit from pre-completion purchase of royalty oil. The most obvious benefit to Alpetco would be the (1) outright purchase and resale for profit of Alaska royalty oil. Given present crude market conditions in the South 48 and existing government regulations, this appears unlikely. However, with an option to purchase up to 150,000 barrels per day at a price enabling them to reach West Coast ports with North Slope crude at a delivered cost to them under \$12.40 per barrel (11.45 FOB Valdez + 0.95 transportation) and with the West Coast spot market at \$13.00 per barrel or more currently, the opportunity is surely open for them to offer North Slope crude at substantially discounted prices and still retain a considerable profit margin. Whether they actually sold large amounts of crude at discounted prices or not, the market price for North Slope crude would probably be reduced in West Coast markets. There would be no offsetting increase in Gulf Coast markets so

AGO 545427

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

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

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

AGO 545428

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

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

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

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

AGO 545429

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

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

AGO 545430

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

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

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

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

AGO 545431

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

6
150 M
60 days

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

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

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

AGO 545432

Monday

1. ALPETCO Presentation

Essentially the same as given to the Royalty Board on 2/21/78, a copy of which is attached.

Expansion on their previous presentation was in the following areas:

- Rising trend of using oil as feedstock for new petrochemical plants.

- Japanese and U.S. mutual interests in having the Japanese involved either as takers of products or as participants in joint venture undertakings.

- The ability to overcome the "Alaska disadvantage" if ALPETCO runs their facility at 10 percent higher capacity than lower 48 plants, which they expect to do with the assured supply.

- Want gas liquids if they become available. Will design their cracking unit to accommodate gas liquids. Believe that demand will be such by the time their plant comes on stream that if one plant is feasible, so are two.

Questions and Answers revolved mainly around:

- Volume: Percentage vs. specific amount.

- Alaska Disadvantage: Seize an opportunity to see if it is viable here vs. assured supply.

- Japanese Interest: Security of stable supply.

- Local Hire

AGO 545508

Alaska State Legislature

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

TRANSCRIPT OF TESTIMONY OF

ALPETCO

March 13, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:	Representatives:
Chairman Mike Colletta	Chairman Bill Miles
Pat Rodey	Charley Parr
Bill Sumner	Chat Chatterton
John Sackett	Joe McKinnon
Kay Poland	Al Osterback

CHAIRMAN: The Senate Panel of the Special Committee that was appointed for review and evaluation of the Governor's Resolution dealing with the sale of the State's royalty oil. The other members of the committee to my immediate right, Senator Kay Poland, Senator Bill Sumner, Senator John Sackett and Senator Pat Rodey. The House likewise constituted a committee and that's chaired by Representative Bill Miles who will introduce his own people. It's at least the intent of the Senate Panel for these first two days of hearings that they're nothing more than informational hearings to acquaint us with what has transpired by the successful, or tentative successfully award winner, and the State's position as to why that specific company or group of companies was selected. The Senate side most definitely comes in with a little bit of a disadvantage insofar as that Representative Miles' committee has had activity in the interim in this area so an apology before (cough-indisc) if meetings do not seem to generate the type of enthusiasm as some might hope. Bear with us, it's only the first two we're going to become acquainted with what has transpired. With that Representative Bill Miles can introduce his people.

CHAIRMAN BILL MILES:

AGO 545509

Thank you Senator Colletta. I'm Bill Miles and to your right is Senator, or Representative Charley Parr and Representative Chat Chatterton. I certainly want to concur with the opening comments made by Senator Colletta as I think as our intent we have, at least I have spent a good deal of time working

with the contracts to listen to your presentation gentlemen, ladies and gentlemen, from ALPETCO, and then we would like to ask some questions at this time but certainly would like you to take the full amount of time for whatever presentation you have prepared. Because of the time constraints that may force us to back up possibly tomorrow, we could have some of you gentlemen back to answer additional questions that may be raised. The House plans to continue its hearings on the royalty oil contract Wednesday and Thursday evenings, I think everybody's (indisc). There's plenty of agendas floating around, if you haven't had one I'll see that you get one. And if necessary, on Saturday. We're intending to raise a number of questions so that we can get as much information as possible. The Governor's urged us to act expeditiously on the contract and we're going to attempt to comply because we asked him first to act expeditiously and hence, if there are some questions that can't be answered we will try to put them in writing beginning of next week in an attempt they can be answered within 7-10 days in writing. And with that unless you have additional opening comments Senator, we will turn it over to the representatives from ALPETCO. If you will please introduce yourself and your representatives and we'll begin.

MR. CHARLES HONIG:

I'm Charles Honig, Chairman of Alaska Petrochemical Company and I will preside during our presentation and I think it would be more appropriate Mr. Chairman if we introduce the people as they participate in the presentation, if that's agreeable.

CHAIRMAN: Your Pleasure.

MR. CHARLES HONIG:

Mr. Chairman and Committee Members, no business endeavor is stronger than or better than the people associated with it. From its beginning ALPETCO has associated world-recognized specialists and experts in each aspect of our proposal. These people are dedicated and will continue to work with us as we go forward. They have been with us in most parts of your state and met with the Royalty Board at many locations. We're here to answer any questions on any aspect of this project and if we cannot answer them as Chairman Miles suggested, we will get the answer as soon as possible. We've agreed to spend our time and effort and money to fulfill this contract because it will be a profitable business venture and we're interested in profits. The State of Alaska will incur no risk nor lose any money in the process. When we succeed, your gain will be substantial and it will be permanent. I'd like to just project some slides if I may to illustrate what we would like to talk about today. We'd like to talk about the ownership of our company, the benefits to the State of Alaska, the viability of the project, and then summarize.

AGO 545510

The ownership of Alaska Petrochemical and it's better if we start at the bottom of the chart and go up, as you can see there are three stockholders of ALPETCO: Alaska Consolidated Shipping, Barbour Oil and Alaska Interstate. Alaska Consolidated Shipping owns 20%, Barbour Oil Company, which is a privately-held family company, owns 20%, and Alaska Interstate which is a listed company, owns 60%. Alaska Consolidated Shipping is made up of seven stockholders. The first six listed are, Alaska Native Regional Corporations, which each own 8-1/2% of Alaska Consolidated Shipping. Collectively they own control of that company. Forty-nine percent of ACS, as we call it, is owned by Seatrain Lines, Inc. (ph), also a New York stock exchange listed company engaged in the function shown on the chart. Barbour Oil Company provided the leader of this project in its early phases and whose untimely death we all regretted, because he was a real driver of the project and that was John Barbour. And in honor of John's efforts, we would like to dedicate and name this refinery the Barbour Refinery. Alaska Interstate is an Alaska Corporation, has always been an Alaska Corporation, and consists primarily of the gas transmission and distribution company in Anchorage and Kenai because it was formed right after Alaska became a state in 1959. We're engaged also in exploration production of liquefaction of natural gas in Indonesia which is currently being exported, liquefied and exported to Japan. We're engaged in exploration and production of oil and gas in the U.S. We have an engineering and construction company in the gas processing facilities area which has been in business since 1946, and we're also engaged in pollution control, sulphur recovery processes and manufacturing. So those are the owners of Alaska Petrochemical, the only owners.

Let's talk a moment about benefits to the State of Alaska. We'd like to discuss those listed here. No risk. No subsidy. Additional employment. Additional taxes. The Alaska endowment trust. Shipping capability. Specialized training. Local hire. And controlled industrial development.

First the no risk, no subsidy. Our contract provides no subsidy to ALPETCO. There are no price concessions. We included in our capital requirements all of what are called the off-site facilities, such as ports, docks, utilities. We agreed that we would take no interim crude, no crude during the time the refinery is being put together unless and until we have obtained a commitment for the permanent financing. And once we've obtained that then the contract permits us to take crude on the interim basis, because once the commitment is obtained then everyone can be assured the project is going forward. We obtained from the Department of Energy a favorable opinion which protects the State of Alaska, if we do take crude on an interim basis, and merely provides that an exception in effect so that Alaska can take back the crude even if we have purchased some in the interim. Probably the most important

AGO 545511

no risk area that is provided in the contract is what we call performance benchmarks. And those benchmarks provide that the contract may be canceled by the state if ALPETCO fails to obtain each benchmark in the contract and here is a summary of those. During the first six months after ratification of the contract we must give monthly progress reports to the state, thereafter, quarterly reports. Six months from the time the contract is effective, we must have invested at least 2 million dollars. We must have informed the state of our site selection, and we must have begun the optimization design of the Petrochemical facility. Within 12 months we must have invested at least 3 million dollars. The 18 months time period or benchmark is probably the most important, most subsidy of all, it not only requires that we must have committed at least 10 million dollars but more significantly it requires that we must have contracts for the sale of at least 70% of the products the plant would make and we must have obtained financing commitments for at least 1.5 billion dollars, both permanent and interim construction commitments. It provides we must have completed our BIA and we must have filed for permits and finalize plant design. So that's why I said earlier if we make the 18 month benchmark which involves getting financing commitments, then the project is assured of going forward. Then we have additional benchmarks at 24 months on up to 72 months and except for the 30 month one which says we must commence construction by then, the others relate to money and indicate the minimum amount we must have committed to spend by those times, the last one being 72 months we must have committed to invest at least 1.5 billion dollars. So those are the benchmarks for performance provided in the contract. There are provisions for some extensions of time by the state up to, I believe, a maximum of 6 months, pertaining to some of those requirements.

The other major contract items, our economics, our planning, our financing, are based on using 150,000 barrels of crude oil per day. We will purchase that royalty -- that as royalty crude up to that amount of 150,000 barrels per day. It will come first from and then maybe all from up to 85% of Prudhoe Royalty Oil. The state wanted to retain initially 10% and later 15% because of North Pole Refinery of the Prudhoe Royalty Oil and would sell us no more than 85%, because that's less than 100 and because we are dedicating about 2.5 billion dollars to a on-the-ground facility in Alaska. It is essential that we have the 150,000 barrels a day as a feed stock. So in the event that we are not receiving at least 145,000 barrels a day, for as long as a 2-month consecutive period, we may then ask the state to sell us royalty crude from locations other than Prudhoe Bay, but only if we need it to make up that short fall, and then only up to but not to exceed, 70% of such royalty crude. The state insisted on reserving and keeping 30% of that royalty crude which we would not have a right to ask for. So that is simply make-up oil and it is available only to bring us back up to the 150,000 barrel a day limit.

The contract also provides that we will pay the same in-value price that the state would receive had it not sold the oil to us. In addition to that, should the state incur any expenses in connection with making a sale to us in kind, we have agreed to pay those additional costs.

The next item is--requires a public referendum in the event that we request any reduction in price that we would pay, anything, any request for price below the in-value would have to be voted on--would have to not only be acted on by the Legislature but would have to require a public referendum to approve any price concession. We agreed to the point of delivery after long negotiation and we agreed that it would be Pump Station No. 1 so that the State of Alaska does not become a shipper, which it did not want to do. We agreed that we would provide up to 30,000 barrels a day of fuels for in-state use, Arctic fuels, other fuels for use in Alaska. Environmentally, we agreed to comply with Federal and State rules and regulations including all supplemental state standards whether or not those supplemental standards are required by law. We agreed we would observe them even if some of those being contested currently are not upheld. Those are the principle major contract terms.

I'd like to ask Willard Hanzlik who's the Vice-President with ALPETCO and Alaska Interstate if he would talk about additional employment and additional taxes among the benefits, Willard.

MR. WILLARD HANZLIK:

The next item on our list of benefits to the state is additional employment. We believe it is one of the most important contributions that this project can bring to the State of Alaska for employment in this industry. Refining and petrochemical industry represents permanent employment, it is non-seasonal, it is not (indisc), it is permanent, and it creates because of the diversity of the different jobs available in the manufacturing process, opportunities for workers to upgrade their skills and to have careers that develop within the industry. On a preliminary planning basis, our experts who are experienced in the organization and operation of facilities such as the one we contemplate, have indicated that these are the types of jobs for the various refinery units listed on the left which will be needed when this project is brought into operation. We have shown minimums and maximums because at this point in time it is literally impossible to determine precisely the number of employees that will be required. However, the range of 1,900 to 2,500 is a fair range and representative of the number of permanent operating and maintenance employees that will be required by a facility such as this. This does not include the support employees which would--the jobs which would be created in the community to support the facility.

AGO 545513

To summarize the--those other jobs and total employment picture, during the construction phase which is expected to last approximately 3-1/2 years, a range of between--an average of between 3,500 and 4,000 construction employees will be required by the project. Now those numbers will not land all simultaneously to start the project for of those there will be a build-up and many of the employees which will be in the construction phase of the project will certainly be qualified and have the skills needed to remain and become permanent members of the community and become operating and maintenance employees. To summarize, in the operating phase, the long-term phase of the project, the 1,900 to 2,500 range which I talked about earlier, plus the shipping requirements of the project which would be conducted by our affiliate, Alaska Consolidated Shipping, would require another 250 to 350 jobs and these would be permanent maritime jobs will be discussed later in the presentation. So we are talking about a total of 2,100 to 2,800 permanent jobs. Now this does not include the multiplier of additional jobs which would be needed in the community and those are estimated from 3 to 4 or 5 times so you are talking about a range of 6 to 10 thousand new permanent jobs.

As far as taxes go a project such as this provides a substantial tax base for local and state government because of the considerable amount of capital investment based on a 2.5 billion dollar facility which is what this facility will be ultimately, and based on the projections which we have--are submitting today to the Institute of Social&Economical Research at their request, these are the tax numbers which are--result from the project. On an average year after the project is in operation, talking about a total of 49 million dollars a year. In additional, these are incremental taxes to the State of Alaska, through the property tax structure, through state corporate income tax and through gross receipt tax. Over the total contract period of a 27-year period. The project is for over 1 billion dollars of additional state and local taxes. One way tolook at the comparison between a facility which is designed for the manufacture of petrochemicals versus a facility that is designed for the processing of crude oil into fuels products, is simply to look on a relative-comparison basis and on the same scale is the two bars on the left side represent an average or a typical fuels configured facility (indisc.-cough) which is to be built in Alaska which would cost with all the support structures and utilities and docks and ports, etc. around 750 million and is estimated at about 500 direct permanent employees would be required to operate that facility. The facility which ALPETCO proposes and which would cost 2.5 billion dollars is shown to be substantially greater in terms of the assests invested, therefore the tax base and also the number of employees is substantially greater, several times greater in fact. Mr. Honig.

MR. HONIG: Thank you Willard.

Another benefit to the State of Alaska and provided for in the contract is what we call the Alaska Endowment Trust which

AGO 545514

is a charitable foundation and the purpose of this trust would be to further the social, educational, cultural, environmental conditions in the State of Alaska. It would be funded by contributions made by ALPETCO beginning after the operation had been in--after we'd been in operation for 10 years and it would be equal to 5% of the net after tax profit beginning with the 11th year after start up. We estimate the average contribution would be 10 million dollars per year and for 10 years that would be roughly 100 million dollars. The trust would be administered by an independent board of trustees unaffiliated with ALPETCO appointed by the Governor and confirmed by the Legislature. Another benefit involves shipping and training of Alaskans and I would like to ask Jim Strupp who is the Vice-President of ALPETCO and also the Vice-President of ACS if he will discuss those subjects, Jim.

MR. JIM STRUPP:

Thank you Charles. Alaska Consolidated Shipping will act as ALPETCO's shipping arm, will act as it's shipping arm in several ways. Because of the lead time between ratification of the contract and actual commencement of actual product shipment, we will have enough time to complete new buildings and provide specialized ships for the product movements and this should give us a very, very good optimization from a shipping cost standpoint. Mr. Hanzlik indicated before, we will also provide (indisc) opportunities for Alaskan citizens in the maritime industry, those jobs should approximate 250 to 350 full-time maritime jobs. Alaska Consolidated Shipping has experienced management in ship building, seatrain lines, one of the members of that company is in the ship building business and currently employs 620 employees building tankers as well as other vessels. We have experience in the ship chartering business, manage and charter over 25 vessels at this time and also are experienced in port management, both in the United States and overseas. As you may know, the majority of Alaska Consolidated Shipping is owned by six Alaska Regional Native Corporations, Koniag (ph), Cook Inlet, Aleut Corporation, Bristol Bay, Chulista (ph) and Chugach. And that's backed up by Seatrain Lines, one of the largest shipping companies in the United States.

I'd like to talk now about specialized training for Alaskans. I've kind of broken this down into two phases, that which is already happening and that which is planned. The already happening category, several months ago John Gunderson who is also a director of ALPETCO and a member of the Aleut Corporation, I traveled to Piny Point (ph), Maryland and met with officials of the Harry Lundberg (ph) School Seafarers International Union there. At that time we made arrangements for the beginnings of training programs for Alaskans and currently we have two students from Alaska attending that program, Mr. Ray Klack (ph) who is a member of the Doyon Regional Native Corporation, Mr. Fred Haas (ph) of the Cook Inlet Corporation. They are enrolled in a 3-month basic seaman course and are guaranteed employment upon leaving. The school pays for the total cost of their training, Alaska

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Consolidated pays for their transportation to the school. They have indicated to us that they will be more than happy to take in each of their classes several Alaskan citizens as we proceed. We've also made some training program scheduling at our Pride Oil Refinery, which is located--which is owned by Seatrain Lines and located in Abilene, Texas. We felt that it was important to begin schooling of Natives, Alaskan citizens in the basic refinery techniques. We have currently down there in a job rotation program, they've been there for the last 2-1/2 to 3 months, Mr. R. C. Credo Jr. (ph), of the Sealaska Native Corporation, and Mr. Lauren J. Hoight (ph) of Cook Inlet. They'll be asked to come back to Alaska once they complete their training and work with us in additional recruitment programs and development of our planned training programs down the road.

We are also planning extensive training programs for Alaskans in all phases of shipping, and plant operation, plant maintenance. These will be in depth programs conducted here in Alaska and outside depending on the area of expertise needed and these programs will be coordinated with the help of Brown and Root, Chem Systems (ph), Alaska state officials, and labor union officials. With that I would like to turn it back to Charles.

MR. HONIG: Thank you Jim.

Next we'd like to hear from a Senior Vice-President of Brown and Root who's been working with us since the beginning of this project and that's Jimmy Norris from Brown and Root. I might tell you a little about his company that he might be too modest to mention. Most of you probably know that Brown and Root operates world-to-wide, it's one of the largest and most diversified engineering and construction companies in the world. Last year I think it had the largest volume of any U.S. construction company. It's a subsidiary of Hal of Burton (ph) which in 1976 had almost 5 billion dollars in revenues and it has a shareholders equity of approximately 1-1/2 billion dollars. It's experienced in Alaska, it built the production facility for BP on the North Slope, it was a joint venture in two northern segements of the Alyeska Pipeline, it's currently building an industrial complex for the big three industries in Alaska. It's experienced in design engineering construction of refineries, petrochemical facilities and off-site facilities. And in Alaska it works through Alaska Constructors which is a union shop company. Jimmy would you like to talk some about the labor policies we will follow.

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MR. JAMES C. NORRIS:

Thank you Charles. Since most of the work that we would do is out in front of us, sometime after hopefully you gentlemen see fit to ratify this contract. We will speak briefly of two areas: labor policies would be the first one. The work that Brown and Root does in Alaska would be done through its subsidiary, Alaska Constructors, with headquarters in Anchorage. Construction would be by Alaskan workers insofar as possible. We would maximize the employment of Alaskans. We would do everything possible to work with the local unions and with the Alaskan government to train Alaskan workers using techniques that are already established. I think Mr. Hanzlik mentioned awhile ago that we're looking at 3,500 to 4,000 average construction employees for a 3-1/2 year period. Many of these people can be trained as permanent employees as plant operators and maintenance personnel.

What we want to offer you gentlemen is a clean industry, environmentally safe plant, it's a controlled industrial environment. It's a plant that I have seen over 30 years in Houston, I have watched the growth of the Houston Petrochemical facilities in the Houston area for that length of time. We can say now that in Galveston Bay, which is adjacent to the ship channel, that there is essentially no pollution. It's an area that's good to fishermen, sports fishermen and commercial. It's good to the residential people, it's good to the government, the Manned Space Crafts--Manned Space Craft Center is just nearby. All of these people live together harmoniously and the petrochemical industry is the biggest--one of the biggest employees of people in the Houston area. As a--I guess something that is indicative of the pollution-free environment is that last week I read something published by the State of Texas that 1977 was a record year for one of our delicacies which is the Blue Crab. Some 7 million pounds came right out of Galveston Bay where all of these petrochemical industries are.

Finally, we want to say that this is a highly capital intensive facility. It's a very sophisticated type of industry and it's also very synergistic. What it's going to do, it will attract other petrochemical facilities to this one as well as what you call the downstream plants which manufacture the polyethylene film and the bottles and such things that you would have from plastics. Thank you.

MR. HONIG: Thank you Jim.

One final point on the matter on economic and social aspects, I'd like to read an editorial that appeared in the Anchorage Times on Sunday, February 19, written by Bob Richards who is the Economist and Executive Vice-President of the Alaska Pacific Bank, because it is particularly good in summarizing

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what we've been talking about here. It reads as follows:

This week the administration is to deliver to the Legislature its recommendation regarding disposition of the state's royalty oil. Although several experts have questioned the viability of the four proposals before the Royalty Oil and Gas Development Board, it should be noted that the four bidders have been working closely with the state over the past few months to develop plans that make sense for all parties. Now consultants, Bonner and Moore, Associates, Inc., have concluded that at least three of the four contenders are fully qualified.

It seems to me that anyone concerned about the stability and long run health of Alaska's economy should give careful consideration to this marvelous opportunity to expand the vertical integration of Alaska's industrial base. Our willful act of instate processing of our resources has contributed to chronic, abnormal fluctuations in Alaska's economy. Expanding the manufacturing operations in Alaska will help create a more stable and, therefore, more socially healthy economy in Alaska. Additionally, the ptetrochemical industry brings substantial benefits far beyond those of many other industries. It is highly capital intensive and one of the lowest labor intensive industries of any of our nations basic industries. Therefore, expansion by the petrochemical industry results in very little population impact. The highly automated petrochemical operation requires very few workers and therefore imposes very little additional burden on public services such as schools, hospitals, highways, and so forth. So it is very clear to see that the petrochemical industry relative to other potential industries, imposes a very small social cost.

But what about the other side of the coin? What does this industry do in the way of creating social benefits? Again, in this regard the petrochemical industry is a star performer. Its first social benefit results from its employing highly skilled, well educated, and highly paid employees. These people generally have a high participation rate in community affairs. Their high incomes are taxed commensurately high, and their socioeconomic station in life generally implies fewer social problems in the sense of crime, disease, and the like.

The second social benefit emminates from the petrochemical industry is its contribution to creating a more stable economy. The industry is virtually non-seasonal; as we all know those plants down on the Kenai Peninsula keep producing 365 days out of the year. Alaska's other basic industries fishing, forest products, and tourism, are highly seasonal industries. As a result, typically, employment in Alaska in January is one-fourth below the level of employment in July. Such seasonality creates all sorts of problems. The expansion of the petrochemical industry in Alaska will help considerably to reduce the overall seasonality of employment in our state. Another way in which industry employment varies is it swings from year to year.

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This phenomenon of course, is referred to as the business cycle. Again, Alaska's fishing and forest products industries are highly cyclical industries. Petrochemical industry, on the other hand, experiences considerably less cyclical fluctuation. Therefore, the expansion of the petrochemical industry in Alaska would reduce both the seasonal and cyclical fluctuations in our economy bringing about a considerably more stable employment situation.

The third major social benefit from the petrochemical industry results from the huge taxes and other forms of government revenue generated from this industry. The key factor here is that revenue flowing to both state and local government exceeds by far the additional burden which the industry and its employees place on state and local government. So there are all sorts of excess funds available for the pursuit of a whole array of social objectives, parks, bike paths, better schools, better health care, and on and on and on. This then is what leads me to a very important conclusion which we should keep clearly in mind. It is simply this--because of the huge public revenue generated by the petroleum and petrochemical industries, this type of economic growth is not only compatible with but indeed is conducive to the pursuit of the whole array of our non-economic objectives.

Perhaps I can summarize by acknowledging the general positive relationship between our quality of life objectives and our economic development. Here we have the opportunity to encourage an industry which will bring wages, highly skilled, well-educated people to stable employment and which many fold more than pays its own way in terms of social impact. The social and economic attractiveness of the petrochemical industry is self-evident. So we've discussed these benefits to the State of Alaska -- no risk, no subsidy, additional employment, additional taxes, the Alaskan Endowment Trust, the shipping capability, specialized training, local hire and controlled industrial development. We've talked about ownership. We've talked about benefits to the State of Alaska. We'd like next to talk about the viability of this project.

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There we will talk about management, descriptions and scope, marketing and financing. The organization and management doing what we call the development phase, which is where we are right now, is we have a Board of Directors, as shown -- one of the persons on the Board who is here today but will not speak is Terry McCall; many of you know. The Chief Executive Officer we'll hear from later is Gordon Cain and then we have people and companies involved in the technical aspects, the marketing aspects, the legal aspects, shipping, engineering design and construction, finance, legislative affairs, planning, training for local hire and all of these functions have been active since we started working on the ALPETCO project. One of those that has been very helpful to us in both marketing and in technical considerations is Chem Systems, Inc. and we've had two persons work with us there, the President of the Company, Peter Spitz and the Vice-President of the company, Chuck Campbell. Some of you may recall, Chuck Campbell spoke at the Petrochemical seminar in Anchorage late last year. Chem Systems is one of the leading international firms specializing in marketing and technical support of what we are proposing to build. They have offices around the world. They have a staff of 80 full-time professionals. Their clients include most of the world's leading oil and chemical companies. They're experienced in all phases of petrochemical development worldwide, including the United States, western Europe, Japan, and the Middle East. And they're experts on supply and demand and economics in the field of petrochemicals.

The other, most important ingredient to our management, is the person who's going to be the chief executive officer of our efforts. This person is Mr. Gordon Cain. He has over 30 years experience in the petrochemical industry. As a successful, seasoned chief executive officer, he's been responsible for promotion, putting these together, forming the company, staffing and managing petrochemical facilities in the United States. He's had experience with the Japanese. He's put together a petrochemical joint venture company in South America and he's had experience with petrochemicals in Europe. He is currently President and one of the organizers of Petrotex (ph) Chemical Corporation in Houston. Prior to that he was -- he headed up the petrochemical and chemical activities of Continental Oil. He's also currently Chairman and an organizer of Petrocrema (ph) Argentina S.A. in Buenas Aires. I'd like to introduce Mr. Cain to talk to you about what this facility will do and will look like. Gordon.

MR. GORDON CAIN:

Well Gentlemen, here is a rather simple diagram of the units that we will have in the ALPETCO project. The core of this operation will be an oil refinery which is shown on the left side of the screen. And this refinery will be, for all practical purposes, the same as any of the other refineries that have been proposed to be built here. The one difference in it is that we will take the part of the gasoline fraction that is not necessary for the Alaskan market and some part of the heavy fuel and convert that into a petrochemical feed stock.

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Now from this point on precisely what we do is not clear because this will be determined by the market and by the nature of the partners that we get. But in general terms this will include an Aromatics plant which will make such compounds as benzine, taulowene (ph), zyolene (ph) and an Olefins (ph) plant that will make compounds like ethylene, propylene, and butadiene. And then there will be downstream plants from both the ethylene plant and the Aromatics plant which would make such things as polyethylene, polypropylene, ethylene lycol which is antifreeze, ethyl alcohol, which is a gin or any other such place; polystyrene, polystyrene fenol -- those are all the number of possibilities that might go into boxes that are labeled one, two, three, four, five over there. Now this will be a large complex and will have a very substantial utility requirement, both for electricity and for steam. And so it will be necessary for us to build a large steam, electric plant and very likely the balance of this is such that we will need more steam than we will electricity so it will have some excess capacity to generate electricity. So it is possible that this plant will have the capacity to sell electricity to any of the nearby utilities or even preferably to have one of the utilities build and operate that part of the plant for us. In addition, if there is coal available at the time we go on stream, this could very easily be a coal fired plant. We think by that time the liquid fuels that we will make will be more expensive than coal and it would probably be more economical for us to operate this with coal firing if the coal is available.

Now going back to the refinery for the minute -- as I said, this refinery is essentially the same as the refinery that has been proposed to be put here by some of the other people and the economics of this refinery part of it, the market that it will serve and so forth, are probably the same as the things that have been proposed before. And in examining the viability of the refinery, we think of course this is a viable project -- and we have support for this in that there were at least two or three other proposers that also wanted to build refineries. Now this was, in spite of the fact that everyone recognizes the cost of construction and operation in Alaska, is greater than the cost of construction and operation elsewhere -- but in spite of the fact, we and other people think that we can overcome this Alaska disadvantage in the refinery. Then if you look downstream from that, the Alaska disadvantage, to the extent there is one, gets to be much less in the downstream projects than it was in the upstream project, in the refinery. And by downstream I mean the Aromatics plant, the Olefins plant and all of the plants that use the olefins. Now the reason for this is that in the refinery you upgrade the crude oil only a relatively small amount per barrel. And as a result, this Alaska disadvantage is a fairly significant proportion of the total cost. On the other hand when you go from these petrochemical feed stocks to things like polyethylene, you upgrade the oil a great deal and this same Alaska disadvantage

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is proportionately much less than the downstream part of it than it is in the refinery, so that the addition of these petrochemical facilities to the refinery improve the overall economics of the project. And, of course, in improving overall economics, they increase the probability of success of this. Now this is a big, complicated project and in spite of all of the organizations and facilities that you have seen on the earlier charts, it's going to be a big thing to do and it would tax -- it would be frankly beyond our resources to do by ourselves. And so we fully intend to take into the different parts of this enterprise partners who can bring to it know how in the operations of these particular things, people who are knowledgeable of this and money and agreements to take products. And this is an essential part of our plan and we have many indications of strong interest on the part of these potential partners. And there's a good reason that we should get this sort of interest because the petrochemical business in the United States, and in fact all over the world, is sort of divided into two pieces. About half of it is run by oil companies who have sources of raw material and can break that into petrochemicals with all the advantages of having the raw materials supplied. The other half consist of chemical companies who buy their olefins and aromatics from oil companies and those companies are continually uncomfortable at being in the position of not having a resource of raw material for their operation so it is that kind of company who wants the benefit of the certainty of supply that it would have here in Alaska, that we will look to find partners to help us carry this operation out successfully.

Now the reason that these partners want to get into such enterprises as this is because they need the products that we will put out and Mr. Spitz, who Mr. Honig introduced earlier, will discuss with you the market for the petrochemical products of the kind that we propose to make. Peter.

MR. PETER SPITZ:

Thank you, Gordon. I would like to cover with you now the basis for this project in terms of markets, tentative products and product configurations, economics and feed stocks and also how this project will fit into the overall scheme of things in the world of petrochemical manufacture. This is a very major project, certainly for Alaska and for the U. S. as well, in the sense that it is a large petrochemical facility and one that is needed by the world market at least in terms of quantities for the world market, as you will see.

Now, in starting my presentation, I would like to have you think not so much about the year 1978, but rather the period of 1985 and onwards when many people think we will have quite a different situation in the world of energy, particularly petroleum, scene. The many studies that have been carried out in the world oil situation by such respected organizations as the Department of Energy, M.I.T., the CIA, a number of others, have predicted that regardless of exactly when this will happen, there will be a point in time and probably most likely in the late 80's,

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when the OPEC countries will no longer either be able to or will wish to, supply the overall gap in demand for world petroleum. At this time right now, of course, there is a surplus of oil, you might even say a glut of oil and there does not seem to be an oil shortage, but as you extrapolate world energy demands and the the key role that oil fulfills in it, it is not too difficult to predict that by some time in the late 80's, certainly no later than the early 90's, this situation's going to change quite dramatically and by what very recent pronouncements by the Department of Energy and by a number of other groups, have said certainly confirm this.

On this basis the ability for any petrochemical manufacturer to have at his disposal the ability to buy a significant amount of crude oil for a long period of time through the 80's and 90's and beyond, will be extremely important and will be worth a great deal and that really is almost the key of the entire project and why we think this project will certainly be viable.

Now ALPETCO originally started looking at the possibility of either building a refinery or a petrochemical plant because it's not obvious that you should build a petrochemical plant. As you know, some of the other proposers chose to select a refinery as their objective. But in looking at the relative world demand growth for petrochemical versus fuel products, you'll come to the conclusion, as you'll see in this first slide, that petrochemicals grow and are expected to grow at a lot faster rate than fuel products. Now fuel products that are represented by the two lower curves seem to grow with such indicators as population and GNT and in fact, as the U.S. and other parts of the world cut down on their energy consumptions, they grow at a lower rate than these indicators. And furthermore, when you look at the fact or think about the fact that the world must try to get by with less oil as time goes by since it's a perishable limited commodity, it will actually grow at a lower rate because oil will be supplanted by coal and nuclear energy and by other alternative energy sources of a more far out nature in 20 or 30 years. So you see the predicted growth rates for petroleum products is really quite low and will get lower as time goes by and these are not just our figures, but they are recognized figures by people who publish such things including even the major oil companies. And, on the other hand, the petrochemical growth rates which have been high and which will be dropping as a result of the fact that things can't keep growing forever at 8 to 10% per year, are still very high and will in our judgment and that of others such as Stanford Research, Arthur D. Little, etcetera will keep growing at the rate of 5 to 6% over the next 10 to 15 years. So looking at these two things, and recognizing that there is not going to be a need for too many more refineries in the United States, in fact Shell had said at one time that the last U. S. refinery will be built in the 1980's, was quite an interesting statement, about a year and a half ago, anyway lead ALPETCO to conclude that building

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a petrochemical facility makes a lot more sense. There will be a need, moreover, for petrochemical feed stocks to be made in refineries so that the refinery that ALPETCO plans to design will fit into the overall scheme of things and in that connection we should note that in all parts of the world, other than the U.S., the major olefins like ethylene and propylene have always been made from petroleum feed stocks such as naptha and gas oil and in the U.S. where gas liquids were used over the first 20 or so years of the petrochemical industry, even there in the last several years, approximately 80 or 90 percent of the new ethylene plants have used petroleum rather than gas liquid feed stocks so that is again the point that was very important in ALPETCO's consideration in planning this facility.

Now I would like to cover some of the markets we are thinking about for the petrochemical products for ALPETCO and in the next slide we see that the U.S. West Coast has a fairly large market for petrochemicals because it consists of 28 million people and as I will note again later, it actually has a very, very limited number of petrochemical facilities and actually no world size ethylene plant. This is almost an anachronism. Other companies have thought of building a plant there but have been unable to do so and we therefore look at the West Coast market as a very logical and very important market for the ALPETCO project since this market is currently supplied through rather long and expensive transportation lines from the U. S. Gulf Coast. The other important market we're thinking about and that's very important to the ALPETCO project is the remainder of the Pacific Basin, which is kind of hard to show on one slide but it includes Japan, Taiwan, the Phillipines, Hong Kong, which has a very high import rate of plastic, plastic resins because it exports a lot of plastic fabricated products, Thailand and Malasia, Indonesia and the Phillipines, and not shown, the West Coast of Latin America and some other countries. And this market is growing rapidly because the population is large. Our company has made a lot of projections and has shown that this market will be able to buy a lot of petrochemicals, and will eventually build their own plants, but not for some time -- in many cases, except for Japan, of course, and will be a very important market for a project in Alaska. Now this market has been supplied, to a large extent, from Japan, but in the last year or two Japan has been losing this export market partly to the U.S., because the facilities in Japan are becoming somewhat antiquated and in many cases because feed stocks in Japan are high and because Japan has other problems that will be discussed by the next speaker. So we're talking about supplying the U. S. West Coast and the Pacific Basin, which are currently being supplied from two areas, mainly the Gulf Coast and Japan, which are in a sort of transitional situation. But now what is happening on the Gulf Coast? The situation in the Gulf Coast is that in the past petrochemical plants were built there because of inexpensive gas liquids and because of a highly abundant petroleum and natural gas feed stocks there. As you, I'm sure, know these gas and petroleum products are now in decline there. Every year production rates go down, particularly for petroleum products and will keep decreasing

and so the logic of building plants on the Gulf Coast is no longer there except for the existing infrastructure which will obviously continue to be an attraction to some companies who want to locate there. But the feed stock advantage will no longer be there, particularly as crude oil reaches world market levels. Everybody will be using feed stocks of roughly the same price as time goes by. In Japan where, I said before, there are problems with high feed stock prices and plant siting, there will also be difficulties so what we're really seeing now is a kind of a structural reorientation of the industry where petrochemical facilities are not as likely to be built either on the Gulf Coast or in general near existing downstream facilities but rather in areas where crude oil or natural gas or gas liquids are being produced. This immediately brings in mindthe OPEC countries which, as you know, have great ambitions to build petrochemical plants and are in fact building some plants. The problem with the OPEC countries though is that number 1, the construction costs there are even considerably higher than in Alaska on the basis of having absolutely no infrastructure in the sands of the Middle East. We have construction factors relative to the Gulf Coast in the area of 1.6 to well over 2 times that of the Gulf Coast construction cost versus a 1.3 to 1.4 factor frequently used for Alaska. Nevertheless, the OPEC countries will build some plants and will be entering the world market. But to put this in perspective, however, even if two or three projects are built in Saudi Arabia in the next 10 to 15 years, and let's say 2 or 3 or 4 more plants in other parts of the Middle East, this will as you will shortly see, reprepresent only a very small percentage of the world market and certainly not the kinds of production quantities that will dramatically alter the world situation and something to be terribly concerned about.

And so, and then there are other problems, of course, is that the OPEC countries are somewhat unstable in the eyes of a lot of companies that would like to produce there and the fact that these companies are over in the OPEC countries like Saudi Arabia and Iran and Abu Dhabi and so forth, means they are looking for alternatives to what they would like to continue to do on the Gulf Coast and cannot do and that is I believe also why we were able to attract quite a bit of attention to a project in Alaska.

Now we will start looking at the specific markets and market projections that we are contemplating for this project and we're basing some of our thinking on. The next slide is I think interesting because it shows you the power of geometric growth as it were. The 1980 figures for ethylene, propylene and benzine, the three most important petrochemicals, are I think accepted by everybody who knows the business as being quite representative of what will be the situation at that time. Assuming a growth rate as I've indicated before in the area of 5 to 6 percent per year and multiplying this to the 10th and then to the 20th power, which is what you're doing, you arrive at very large amounts of ethylene, propylene and benzine. Now we may be wrong about these projections, though

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we are not out of line with other people who make these. Maybe the growth rate in the 90's will only be three or three and a half percent. But even if we talk about ethylene being only 70 billion pounds, you can still see the huge amounts of additional capacity required just for the United States alone. And when we contrast that with the ALPETCO case I've shown and as you see we show it as a case -- there are other cases that make less and more ethylene and propylene. You can see what a relatively small percentage of U. S. production this actually amounts to and this will be shown again in another slide.

The next slide is taken from a presentation that Union Carbide made to the security analysts a number of months ago -- it's still quite up-to-date. Again it shows the supply of ethylene on the upper part and the reason it (indisc.) each project or projects each year at a certain amount of capacity, the lower (indisc.), the smooth line represents the effective capacity because these plants will operate somewhat lower than the rate of capacity and the lowest curve shows the demand projections -- the reasons the curves digress a little bit is because this really should be shown on a log lock scale to be most properly shown. But in any case, the point is that every three or four years supply catches up with demand -- I'm sorry, demand catches up with supply, unless more plants are required.

The next slide please.

I indicated before we were looking at the U. S. West Coast and here Chem Systems has made a number of studies and facts. I gave a speech at the National Petroleum Refineries Association Petrochemical Meeting last March from which this is one of the presentations or exhibits and this shows that the West Coast market is large and getting larger. None of the materials I show here are actually made on the West Coast today with I believe one exception, polyethylene, which is made in very small quantities, almost negligible.

The next slide please.

It shows the same situation in numbers roughly, again showing this high growth for petrochemical derivitives, ethylene, (indisc.), polyethylene and styrene on the West Coast. You see, for example, polyethylene demand now is in the area of 700 million pounds, slated to grow to 1.9 billion pounds. These demands must come from somewhere and we believe that Alaska, an Alaskan plant, could supply a certain percentage of these and we would only need to sell -- need to fulfill approximately 20 or 30 percent or less of West Coast requirements in order for our project to be viable. The number of companies who market on the West Coast would be interested in obtaining products from other sources so our thinking there is not to

become a new marketer of material but work with existing marketers of these materials on the West Coast and we have already talked to them and as Gordon has said before they have expressed considerable interest in working together with us in the form of joint ventures or other business arrangements.

Moving out to the Pacific basin countries, this next slide is our estimate of net import requirements for a number of these countries and that other slide that I showed you, showed for example that carrying all the plants that have been built and looking at the man increases, the region has a need for net import of a fairly substantial amount of these technical petrochemical and this again therefore the market that we want to go after.

The next slide summarizes the ethylene requirements for both of these markets and shows that this for the U.S. West Coast and for other Pacific basin areas totals of ten World Scale ethylene plants are required through 1990 and we are thinking in terms of one plant at least for the time being so that we are looking at selling--we are looking at ALPECTO fulfilling only 10% of this new market (indisc)--expanded marketed requirement through 1990. And in the last slide we show therefore a number of possible chemicals that could be made in Alaska for fulfilling either or both the U.S. West Coast market or the Pacific Basin market and I think this will explain to you why we have not yet chosen the final configuration for the plant. We must decide which of these chemicals to make and we can't make them all because we want to build world skilled facilities which means probably only 3 or 4 of these types of products should be made and they should be made in fairly large quantities. Now leaving the market and addressing ourselves next to the question of economics and Alaskan economics, which has been certainly criticized in some of the articles I have read in newspapers and some of the statements that have been made. Such statements as ridiculous to build plants in Alaska because of markets elsewhere, etc. also that petrochemical should not be shipped all around the world, they should be made where they are consumed. Well, there are some falacies in this, although I must admit, it does represent some national wisdom of the-- perhaps the 50 and the 60's and early 70's. We had an event that occurred in 73 that has changed a lot of things and you know what it was. The ALPETCO Companies are starting to become interested in building petrochemical plants and so a lot of petrochemicals are going to be shipped all over the world. Furthermore, the world trade in petrochemicals was always very large and in fact, contributes very very substantially to the positive aspect of our balance in trade. Were it not for our exports of petrochemicals our balance of trade would be substantially worse. This also, I think, is important to know in connection with some comments that were made that for every barrel of oil that we can turn to petrochemical and export to Japan we have to import another barrel of oil from the Middle East. That's true. However, the value to the U.S.of petrochemical export is roughly five times the value of the oil

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that's imported and so we gain, we have a 5 to 1 leverage in terms of the U.S. balance of trade for converting oil into petrochemicals.

The next point is just how unfavorable are the economics in building a petrochemical plant in Alaska and we fully recognize that there is a disadvantage due to the higher construction costs in Alaska. What we feel are mitigating factors, the factors that will turn the situation around are as follows:

1. We know that the Japanese petrochemical production is expensive because they must import their feed stocks from the Middle East and have very high transportation cost. We feel that an Alaska plant can be competitive in shipping petrochemicals to Japan.

Secondly, as I indicated to you, the logistics in cost of shipping petrochemicals from the Gulf Coast to the West Coast which goes either through the Panama Canal or by hopper car, by rail from the Gulf Coast of California are high and figures indicate that it would certainly be reasonably economic relative to those transportation economics.

Next point is, as I said before, the economics of building petrochemical plants in OPEC countries is high yet they are proceeding. So what really is happening is the world is changing and that petrochemical plants will be built more and more in areas where the feed stocks are because these areas, likely not, in most cases, ship all of their feed stock to world markets that would like to use these feed stocks to aid in their own industrialization program and I think you might say, being accused of being in favor of a project that might have questionable economics could be turned around and could be restated as saying we think that it would be important to find out if it would not be possible to build a viable economic petrochemical facility in Alaska. Because we have a feeling that it can be done and I would like to try it and ALPETCO is taking all the risks in order to be able to do this. And we further believe, as Gordon as indicated, the feed stock security that ALPETCO and it's proposed partners will receive will in our judgment offset the economic penalty that will undoubtedly occur to a subminor extent due to an Alaskan petrochemical facility. Finally, to answer a comment along the lines that well, this facility will be built and then it won't be viable and then you know the State will be stuck with a facility that will not be economic. It is our judgment, working with banks and with financial institutions and lenders, there is no way and I think the bankers will address themselves to this at a later point, there is no way that they are going to agree to lend this kind of money we are talking about here unless they completely satisfy themselves that this facility will be economically viable. The banks do not want to get stuck anymore than manufacturing people do.

A final point I would like to talk about briefly, which I alluded to before, relates to gas liquids versus petroleum feed stocks.

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This has been discussed at some lengths in the Press and elsewhere and is certainly of interest to Alaska because of the North Slope gas and the extraction of gas liquids that has been proposed.

We don't know all the answers on this by a long shot and I think the reports that have been prepared by various consultants including Gardner and Moore, Salidus (ph) Battelle and others don't all agree with each other either which just shows that the problem is complicated. There are a lot of variables that relate to what the final well head price of gas is going to be, what's going to be the price of gas in the United States, the diamond or the lime, the amount of gas liquids that can be left in the gas, the amount of gas, ethylene, that can be extracted and so forth. Again we don't know the answers and we think there is a lot of uncertainty about this and it's impossible to make any firm plans on this. But we can say some things about it that I think go beyond the specific timing and economics.

One, ALPETCO is interested in cracking gas liquid if they were available to ALPETCO and if so, this will be possible because the cracking furnaces that ALPETCO plans to build will at least in part be designed to crack gas liquid if and when they are available to ALPETCO.

Secondly, the amount of gas liquid that are going to be available no matter whose numbers you look at are going to be very ample. There could be enough there to build a project along the gas pipeline if that turns out to be reasonable and economic as well as cracking gas liquids in the coastal region where ALPETCO plans to build a plant. The projects are not at all competitive because neither one of them serves the Alaskan market anyway. The markets that are being served from Alaska are the world markets I tried to depict in my slides and since there is plenty of feed stock in Alaska if one project makes sense, probably two projects would make sense. Not a market question, strictly an economic question. So we don't think these projects, if the gas liquid project were to come about, we do not think it would become competitive if it's decided to extract liquid and to build an ethylene plant for example ALPETCO could even take the ethylene by pipeline from that location and back out again feed stocks from its own crackers. This project could work with such another project on gas liquids with no trouble at all and this is what our planning is based on but the difference is the ALPETCO project can proceed right now, its based on petroleum feed stocks. Petroleum feed stocks are being used, as I said, in 90% of the world's petro chemical facilities and we think, that certainly there is nothing wrong with that and in fact, there is some positive features because from petroleum feed stocks you make not only ethylene but you make a lot of propylene, benzene, butadine (ph) and we are looking at a whole spectrum of products where cracking gas liquids really make primarily ethylene and a small amount of propylene.

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Finally, on marketing strategies, this has been covered to a considerable extent by Gordon. I've talked about the West Coast and Japan but we do have some other thoughts to communicate to you on Japan and here I would like to introduce Mr. Tydings who has a special background in Japan as a special consulate to the Japanese Embassy and in Washington with a great deal of background in U.S Japanese trade relations and a member of the United Nations Consul for Population Activities. I would like to introduce at this time Mr. Tydings.

Excuse me, one minute. Would the continuity of your presentation be affected greatly if we hold him for about 10 minutes?

Not at all. We will break for ten minutes.

(OFF RECORD) (ON RECORD)

Hear his testimony and answer questions until tomorrow. So what the schedule will now read tomorrow at 1:30 Commissioner LeResche and Bonard Lord (ph)3:30.

Unidentified speakers: Will that conflict with 8:30? Sure will. Will that conflict with what? Would that be more convenient for you to go at 3:30 Commissioner? If you have to be at another hearing. I would like to make the other one also. Okay, fine we'll put you on at 3:30. Will Mr. Moore testify at 1:30? Yes, I hope we can arrange that. Yes, Senator Tydings is going to speak; Joe, you want to come over here, please, speak to the Japanese and the U.S. Federal Government aspects.

JOSEPH D. TYDINGS:

Senator Colletta, Representative Miles and members of the Special Committee. I appear here as a special consul ALPETCO. I also appear as one who has some experience in the legislative branch of the State Government and the executive and legislative branch of our own government. I'm also legal consul in Washington for the Japanese government on matters relating to trade with the United States and consul in Washington for the Kaydonrins (ph) which is the Japanese consul of Industrial Organizations on energy matters, Japanese Federation of Power Companies, Japanese Atomic Industrial Federation, and the Japanese Committee on Energy Policy Promotion, which was organized and headed by Ambassador Sheba (ph) until he was just made Czar over all trade negotiations, industrial matters and related Governmental Reorganization. I'm also representing and consuling ALPETCO with respect to this joint venture with the personal approval and encouragement of the Prime Minister of Japan and the approval of the Chairman of the Energy Policy Committee of the Kaydonrins (ph)

Now there are significant strategic aspects to the marketing of this particular plant and this particular project as they relate to the Japanese people and the Japanese nation. Let me just

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refresh your recollection just a little with a more recent history of Japan particularly since World War II. (Cough, indisc) a remarkable degree of energy and know how, Japanese people have been able to rebuild their country after World War II into one of the principal and industrial leaders of the free world. But today they are essentially a nation which imports raw material, adds value to them, and exports them. And the most vital raw material in the Japanese list of imports are the energy raw materials. Japan is forced to import over 90% of its fuel oil and its energy of fuels, other than a little bit of coal they have there. Thirty seven years ago an embargo on oil to Japan by major countries in the world was sufficient to send them to war. That's perhaps, in today's concept, an over dramatization. But the strategic importance of fuel oil feed stocks of petrochemical facilities cannot be over emphasized as it relates to the Japanese people particularly in the 1980's.

The Administer of International Trade and Industry meeting recently issued some statistics which will relate to the Japanese need for increased fuel oil by 1982. And their shortfall in 1982 will be a million and a half barrels of oil a day. Sometime between now and 1982 they've got to find that source of additional fuel.

I think perhaps a word about the relationship in Japanese context between the Government, Kaydonrin (ph) or the Industrial leadership of the country is in order. Since World War II the political leadership of Japan has been divided by a Party call the Liberal Democratic Party. This Party, I would say is a sort of a broad-based philasophical conservative coalition. It is very closely related to the Kaydonrin (ph) or the Japanese Consul of Industry. It is inconceivable that any final decision with respect to the opportunity to participate in so important a project relating feed stocks as this would be made without joint participation by both the government and Kaydonrin (ph).

There is another aspect to the Japanese strategic position in the world today which indirectly relates to this and that is the unique relationship between Japan and the United States. As you know, under the treaties negotiated under General MacArthur at the conclusion of World War II, Japan has not rearmed. Japan's principal trading partner is the United States. The Japanese government and the Japanese people value their relationships with the United States very highly. They are very cognizant of the tremendous strains which have been placed on that relationship by the current trade in balances and particularly by the Japanese exports to the U.S. a number of important commodities which have very strong political constituency. The Japanese government is very aware of the steel caucus in our House of Representatives and in the Senate. They are aware of the constituency which relate to television products, shows to a great variety of U.S. goods which have been competing and not too successfully with Japanese goods in recent years. They are greatly concerned with the possible retaliation from the United States with respect to trade barriers, which could be economically very, very disastrous

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to the Japanese government and thus they have been seeking ways to increase their imports to the United States. There is a major trade delegation in Washington this weekend , sent here purely to try and foster imports from the United States to Japan. If you have followed the journeys and travels of our special trade representative and his deputy in the last weeks of December, you will recall that there was two major meetings in Japan, at which time the Prime Minister stated publicly that his government would make every effort to increase the imports from the United States and, as a matter of fact, he had a shake-up in his entire cabinet. So you have that fact of life of the Japanese government today quite aside from the strategic need of feed stocks or other sources of fuel supply, the trade-in balance and the strain put on you as a Japanese relationship.

Let me, if I might, shift to our own government and our own strategic posture in the United States.

We have seen in the last two years two things, we've seen a basic trade deficit in United States relationship with the rest of the world caused primarily by the need to import oil from the OPEC countries. But in those trade-in balances the great in-balance with the trading nations is between the United States and Japan. Up until a few years ago we were basically equal trading nations. And that Japanese in-balance has caused, as I indicated earlier, protectionist movement in our Congress which we have not seen since the 1930's. The Smooth Holly Tariff (ph) was originally a bill introduced by a Senator Smooth (ph) Representative Holly involving just one commodity in 1930 and before it was through the Congress there were 140 different tariff barriers on it and that led to the whole world breakdown in the 1930's of trade. Now, the position of our government has been since President Eisenhower right through every President, right to the present administration, to try and maintain the United States' role, preeminent role as the greatest trading nation of the world, and we still are the greatest trading nation in the world, and try and keep trade barriers at a minimun. But I can tell you and I think that any responsible reporter from Washington will tell you that pressures on free trade are greater today in Washington then at any time in 30 years. So that United States government has a very serious problem if it's going to maintain our posture as the greatest trading nation and that problem is made greater by the Japanese difference in the balances of trade. So it is this particular project, at this particular time, that is a project in Alaska which would market high value added products, such as chemical products to Japan, with significant dollar amounts, whether we are talking about 40% of the output or 50% of the output or 60% of the output of this plant, this would be a major contribution to the United States trade balances. This particular project at this time falls right in line with what our government is trying to do. We have basic ALPETCO proposal has been presented and briefed to the top career civil servants and our special

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trade representative's office, Commerce Departments, State Departments, Treasury, Interior and the National Security Council. We had to do this at a time when we are not the awardee of the contract, when we would have been basically one of the competitors merely to present proposals as basically presented to you and to the Royalty Board. Without exception reaction to our proposal is that it is on all corners, all four corners, consistent with the international trade policy of our government that when the State of Alaska concludes their deliberation, the decision making process and awards the contract, that the top career and the top decision makers in our government will consider what steps, if any, will be appropriate to take in support of this proposal in light of the vital U. S. national interest. They made no representations that it would be put on the formal agenda between the U.S. and the Japanese trade negotiations, but in my judgment, it is difficult to see given the consequences that it would not be given very serious consideration. In my own judgment, I think it would be on there.

To sum up what I have basically stated, the ALPETCO proposal as it relates to Japan, as it relates to marketing in Japan, is an ideal vehicle for Japan to increase its purchases from the United States which Prime Minister Bacooda (ph) has said they are trying to do and which I genuinely believe they are. It will help provide an additional source of feed stock, a steady safe supply pending on the type of negotiations, the type of joint venture which they may enter into which (indisc.) and negotiates with one or more Japanese groups. And (indisc.) the bottom line of the Japanese it could be a very highly profitable joint venture. From our point of view, the United States' point of view, this proposal is in line with the efforts of the special trade representative is making with the admissions of Dick Rivers and Ambassador Strous made in December which was basically to tell the Japanese government they had to increase their purchase from the United States, they had significant effort to reduce the inbalances and bring the trade balances in line, so that we have a proposal which is right in line with our own policy and which would offer, I think significant advantages to the Japanese people and to the Japanese government. I think it's important to know that the timing of the proposal as it comes in 1978 such as to make just about inevitable, a strong Japanese participation as a possible partner for at least some of the production of this complex. Thank you.

CHARLES O. HONIG:

We've talked about the management and the description and scope of marketing and the last point on viability of the project involves financing. From the beginning we have had as our investment bankers, Lehman Brothers, Kuhn Loeb and E.F. Hutton as our co-investment bankers. And as our commercial banker, we have had Chemical Bank and all three of these institutions have met with us and counseled with us and worked with ALPETCO beginning last July and they have attended royalty board meetings with us in Valdez, Anchorage and Juneau and they have met with us in

New York and Houston and they've been posted almost daily on the progress of this project. So they are an integral part of it and we would like for them to address briefly what's involved in the financing and I'll ask first Tom Kenny, who is managing director of Lehman Bros Kuhn Loeb, if he will talk some about the permanent financing aspect. Tom --

TOM KENNY:

Thank you. Good afternoon, Ladies and Gentlemen. Charles introduced me as the managing director of Lehman Bros. Kuhn Loeb, Inc. This is a brand new firm on Wall Street. It was organized in December 1967 (1977) so it's about three months old. However, we have two predecessor organizations that have been around for considerably greater time than that. Lehman Bros. was formed in 1850, Kuhn Loeb Co. was formed in 1867. Both organizations were important investment banking firms during that more than 100 year period of prior to our merger in December of last year. Both investment banking firms were in a forefront of American finance raising capital during that period. More important American business enterprises in significant industry. And as Charles says we have been associated with this important project since its inception, and our thinking concerning the structuring and implementation of the permanent financing has not changed even though we've perhaps elaborated a bit on it during that period of time since we started speaking of it and what we are talking about is structuring a permanent financing as a project financing. I'm talking about the permanent financing for the project as compared to what the construction financing which is what my friends in the Chemical Bank will address in a few moments.

Now, we have told ALPETCO, and continue to tell ALPETCO, that given the approach that they are using that we do believe this project can be successfully financed on a permanent basis, using traditional sources of capital at competitive capital costs. What I mean is, of course, the interest rates and the other capital costs would be similar to those incurred by other high fray developments of this nature or any other nature in natural resources. As a project financing we would expect a considerable amount of support where the financial structure would come from long term supply contracts running to (indisc. cough) utilizing and using the output of this facility. This will permit us to use a capital structure that probably would be somewhat more heavily step oriented than equity oriented but we anticipated that but certainly there will be plenty of the latter also. In connection with that we would anticipate that there would be participations in the equity of this project or its component parts which you've heard some things about it today by the people who are using the product and entering into the long time supply contracts. Such participation and arrangements would not be unusual but to the contrary something I would expect to take place as Mr. Cain

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develops these arrangements with what he has characterized as his partners in the thing. We have written letters in support of the applications that ALPETCO has been making into the various authorities up here. We stand by those letters, we continue to feel that the structuring as a project financing with long term supply contracts that we can raise the necessary money in the convential markets. These markets will involve (indisc.) issues of both taxable bonds and untaxable bonds. The total amount of the financing we anticipate may, aggregate as you've heard here about 2-1/2 billion dollars, however, we are talking about a project that is going to be accomplished over a several year period. It's also going to be accomplished in several discrete stages. The capital markets as we understand them at the present time and we think we do understand them, and particularly the U.S. long term capital market. That is going to be the major source of this money we think will, in fact, absorb financing of that magnitude without any difficulty.

CHARLES HONIG: Thank you, Tom. I also would like to call upon another investment banker who is Executive Vice President of E.F. Hutton, who also by the way served under both Johnson and Nixon as the public member of the National Water Pollution Control Commission, Jim Lopp.

JIM LOPP:

Thank you, Charles. You know our public relations firm put out a slogan that when E.F. Hutton talks people listen. Which people as you travel around the country you make great mention of that after reviewing the contract the State put together, I believe that when Alaska talks, ALPETCO listens. I--reviewing it suggested that if anything more was traded, I think we wanted to be in the spot of raising the financing of the State. You have a very financable contract at this point of time.

Because of the magnitude of the project, I thought maybe we might just mention a few of the assets of the E. F. Hutton Co. in terms of what we hope to be able to bring to the table to help to raise the capital that is going to be required.

E. F. Hutton Co. is about 75 years old and has a 190 offices in the United States, 12 in Europe, has about 2700 salesmen with representation of about 500,000 or half a million, retail and institutional accounts. So we believe that we will be able to bring a lot of these resources to bear in the placement of the securities.

Last year E. F. Hutton Co. managed to co-manage in the placement of debt securities and equity securities 4.2 billion dollars. As my co-investment banker pointed out, we have been involved in this project since its inception and we have continuously supported the ability of this project to be financed given its economic viability. I think it's important for members of the Senate and House to understand that projects like this have been financed in

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the past on a project financing basis and maybe a few examples would be helpful.

Down Australia way, we've had very huge iron ore projects such as Savage River, Rogue River and Hammersly (ph) which has been financed on a project basis such as we are talking about here. In British Columbia you may be familar with the Four D (ph) coal project as well as the Lorne X Copper project which has been financed on a project basis. I think maybe one of the best. analagous situations to what we are talking about here, is in Indonesia, 21 utilities from Japan, financed a billion and a half dollar L & G facility to supply them with gas for 20 years. This was 100% debt finance and Alaska Interstate who was involved in structuring this transaction, retained the 22% interest in that project. That basically is the type of thing that we are talking about here.

Now, interesting enough let's talk just a quick moment about where these funds are going to come from. The commercial banks are going to talk about their construction funds and revolving credit agreements. We also look for credit to come from suppliers, export financing, medium and long term debts, both taxable and tax exempt and we also believe, and we said this to ALPETCO, that we will be able to raise required equity to support the financial structure of this balance sheet that they have projected. The taxable debt will be provided mainly by, on a private placement basis, with life insurance companies, pension, profit and retirement funds. The tax, exempt portion of the debt and we believe in some of the members of our organization under the banner of another firm, were involved in coming up with the idea of financing the facilities at Valdez on tax exempt basis and spent quite a bit of time on that. and we've taken the analagous facilities, docks, wharfs, and some of the infrastructure and believe that under Chapter 61, Title 44 of the Alaska law, we can finance maybe up to 350 million of this financing with tax exempt bonds. Now this is important to the economic viability or helps support it in that the debt rate on tax exempt bonds is some 2% below that of taxable credit. I think Charles, this would rap up my summary of it.

CHARLES HONIG:

Thank you, Jim. We'd like next to hear from our Commercial Banker and speaking for Chemical Bank is Senior Vice President, Grenville Paynter, who also likes to fish in Alaska.

GRENVILLE H. PAYNTER:

Thank you, Charles. I guess it is appropriate to mention a little bit of Chemical Banks pedigree.

We were started in 1824. We ended up last year with total assests somewhere in excess of 31 billion dollars, we were in excess of 100 million last year, we have capital funds in excess of a billion 6.

The short term or the intermediate term facilities that we are concerned with in the banking side are neither exotic nor esoteric

but are very typical of the kinds of projects that we are looking at these days. They are ones that also many of our cohorts in the banking fields are familar with and we have discussed them not only with existing banks that work with Alaska Interstate but also with banks in Alaska and in other money centers and without exception, we've gotten great expressions of strong interest in these kinds of credits. There are three basic ones we are talking about. The first is at the request of Alaska Interstate, we've examined their situation to determine how best and to raise the amount of equity that they would put into ALPETCO in the beginning. We have determined that a hundred million dollars would be easily raised and we have also told them that we would make 20 million dollars of that available upon ratification of the contract to help them with or supply the money for the start-up cost.

We have further told them that we will take 50 million of that total credit ourself. We have indicated to ALPETCO that we believe that a bank group for the interim construction financing of the refinery could be set up. That under present plans a 400 million dollar commercial bank credit should be satisfactory. This credit would be set up against a take-out commitment from long term lenders. Of this 400 million dollars Chemical Bank would be willing to take up to 100 million dollars and would act as agent for the group of banks that would provide the remaining funds. Other forms of financing such as already has been mentioned, supplier credit would substantially fund the remaining short term needs.

Finally, we have talked with ALPETCO about the working capital requirements, the marketing, the royalty crude oil. This encompasses the phase during construction of the refinery after the company has met the bench marks Charles has referred to in his presentation. Our analysis leaves us to believe that a working capital line in the amount of a hundred million dollars would be adequate and here again, Chemical Bank would be willing to take up to fifty million of this financing. Needless to say, each of these various credits is subject to a satisfactory credit agreement. But in each case they are typical of agreements that we work with every day. I'd like to conclude my remarks by maybe restating my opening comment that the Commercial Bank role in this project is personally conceptionalized is a role that No. 1 we are familiar with and No. 2 we believe can be successfully duplicated on behalf of Alaska Petrochemical Co.

CHARLES HONIG:

Thank you, Gren. The closing comment on the matter of financing relates to joint ventures and I'll just briefly refer to a chart that shows some of the possibilities. This is different from Gordon Cain's chart on the refinery but in petrochemical complex but it shows various ways that ALPETCO can work with others in

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putting together in Alaska this type of facility. For instance, we refer to the center part as the core of refinery and that would be primarily in that respect just sulfur recovery, sulfur removal and the ports and docks might be owned municipally or owned separately from ALPETCO, the utilities likewise. As Gordon said we might bring in a big brother partner, a chemical company who might agree to build a olefins plant or one who might be interested in the aromatic aspects. .. So there are all kinds of possibilities for joint ventures which will result in our associating companies as Gordon mentioned with know-how and money and experience in this particular area.

I'd like to ask Gordon Cain if he might summarize what we have presented today.

GORDON A. CAIN:

Senator Colletta, Gentlemen of the Special Committee, word summary suggests that we are reaching the end of this presentation which may be of some relief to you. So I won't take too long to do this.

You have decided that you want to process your oil in Alaska if you can do this without any penalty to the State. Commissioner LeResche and the Royalty Board have examined the proposals that you have been presented with and they have reached the conclusion that the proposal that includes a refinery and a petrochemical operation (cough-indisc) presented by ALPETCO is the best of the proposals that you have received. Some of the factors that might have gone in their consideration are that this will create three or four times as many jobs and three and four times as much tax money in Alaska as any of the alternative proposals. Also, as I mentioned earlier, the addition of these petrochemical facilities to the refinery improve the possibility of the overall project and increase the probability of success. Mr. Spitz alluded to the fact that this project is not competitive with and probably will help your ability to use your gas liquids later. We would be a potential customer for these gas liquids, we don't want so much of them that it would impose on--impinge on your other project if you decide to go ahead with it. We will both, the gas liquid project and our project, will be competing in a world market in which there are ten or fifteen other plants of the same size that we are and the fact that one of those plants is in Alaska and one of those plants is our plant, will have little significance. Whether this gas liquids plant that is competing with us is in Alaska or Indonesia is not going to make that much difference in the overall competition because both of us are only trying to get somewhat less than 5% of the market that we are dealing with.

Now, you have been told that our project is the best project but you still have a reasonable question is the best good enough.

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Now is this best project one that is likely to go ahead and have a chance for success. Now, if we were talking about a project that is going on stream today or if we thought the future was going to be a continuation of the present, if we thought that there would always be a surplus of crude oil, if we thought that there would always be an over-supply of petrochemicals, we would not be here talking to you at all. It would not make any sense to build this project or to put this much money in this. But none of us and none of the experts in this matter, think that things are going to continue as they are now. Prevailing wisdom is that by the mid 80's there will be a shortage of crude in the world. As you can see, the growth of petrochemicals, even if you used the lowest probable growth, will require that there be on a world wide basis a plant like the one we are talking about, built every six months somewhere in the world just to keep up with the lowest anticipated growth rate. So that although a billion and a half, two billion and a half, three billion and a half dollars is a lot of money in the context of this world petrochemical situation, this is a relatively small part of the whole thing. And the question really is what are the things we have that would make this a viable project, make it possible for us to compete in the world market?

Now this plant will come on stream in the late 83's - early 84. By that time we think that there will either be a shortage of crude oil in the world or it will be obvious that there is going to be a shortage. And since people operate on the basis of what they expect to happen, if people think there is a potential shortage of crude at that time, a source of petrochemical that is located in a political stable region, political special to this context doesn't necessarily mean that everybody gets reelected. It just means that nobody siezes the plant. In a politically stable region that the market price will be a very attractive source of chemicals for users of petrochemicals.

Now, at that point we will have a plant that was completed in the early 80's. With inflation running like it is now, every one of the two plants a year after our plant is built will cost more than our plant will because of inflation. You will have a plant that will be producing petrochemicals that will be growing at at least 5% a year rate, we will be producing less than 5% of the requirement for the Pacific basin for these particular products. We are not looking for a great part of the market. We expect to have one, two or three very knowledgable partners in different parts of this enterprise and with all of those things we think that we can have a, we know that we can have a viable project. Now a question has been raised in the course of this, even with all of this, how do we overcome the disadvantage of the hard cost of operating in Alaska? And this is a very valid question, its one we have to answer for you and its one, equally important, we have to answer for the bankers.

Now, first, we don't think that the disadvantages in Alaska are nearly as great as the construction of the pipeline would suggest.

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We hope and certainly intend that we build this for far less premium than the pipeline was built for.

Second, we expect certain things that will help us to compete with the rest of the world.

Mr. Spitz mentioned some transportation cost advantages which are significant but still not enough to close the gap. The financial people they think that we can finance this with more debt than the normal project. And this is an economic benefit But even that isn't enough to close the gap. The main thing that we have to close the gap is that we will be competing at that point, at least in part, with projects that are being built in Korea, Singapore, Middle East and other places like that, that at least have some possibility of instability and some possibility of interruption of supply.

Now, the project in Alaska certainly has less of that risk. Therefore, we expect that our plant with our partners will be their favored source of supply. We don't expect anybody to pay us a bit more per pound than they pay anyone else because they can't and stay competitive. But we do expect one thing that they can give us that will not cost them anything and that is to give us a larger percent of their requirement then the average. To give us enough--this is so that we can run our plant at a higher than average rate of the other competitive plants. Now, this doesn't sound like much but just some simple facts on this kind of plant. This kind of plant has a break even point of about 70% which means that you don't make any money until it gets up to about 70% and then you start making a lot of money. And with this high break even point it means that at 80% you make some amount of money. At 90% you make twice as much money as you make at 80%. So this is a highly leverage sort of operation. Now if we can run this plant at 10% higher than the average of our competitors, we can more than make up the Alaska disadvantage even if we assume some rather large disadvantages here. Now we expect to be able to do that because the people that we will have as partners and the people that we will have as customers will want to keep this plant alive, will want to keep this assured source of supply in being to the extent that these are Japanese plants. They will want to contribute to the improvement of balance of payments between us and the Japanese.

Now, with all these factors, with the organization we have, with the partners we expect to get and with the help of the people in Alaska, we expect to be able to make this a viable possible petrochemical project and to make Alaska an important factor in this part of the industrial world.

Thank you, gentlemen.

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CHARLES HONIG:

Thank you, Gordon. In closing I would like to just flash on the screen for a moment the eleven recommendations, contractual recommendations that Mr. Miles' State Energy Policy Committee made last year. We believe that ALPETCO has -- we were conscious of these, as we negotiated the contract and we believe we have met all eleven of these contractual recommendations. And those were first that the contracts have a cancellation or termination provision which ours has -- that it require local training and hire, which it does; that completion of the refinery be tied to the sale of crude to assure there would be a refinery and this exists in our contract. That the in-value price be paid which we agreed to do. That there be compliance and security provisions in the contract which there are. That the point of delivery be LACT meter one, which it is. That there be no subsidy and there is none. That the method of payment should minimize the float of the funds and I assure you it does. That in-state fuels, use of fuels, be provided for, which it is. That in-state processing be required by the contract, which it is and that the quantity not be guaranteed by the State, and it is not. Thank you gentlemen. I apologize for the length of the presentation but there has been so much talk about it over a period of time -- we assembled these people here, we felt we should address it fully. Alright, thank you very much and as we stated in our opening remarks that we needed some information (indisc.)

CHAIRMAN MILES:

Thank you. I'm tremendously satisfied and pleased with the project. I don't think there's any doubt about it, especially after what we heard today. Perhaps one of them would like to comment on how the effect of committing undiscovered reserves to the project would affect the financing.

CHARLES HONIG:

Jim?

ALPETCO REPRESENTATIVE:

Okay. Would you care to repeat that question please, I didn't quite catch it. The committing of reserves?

CHAIRMAN MILES:

Yeah, the 70%, the undiscovered -- essentially undiscovered reserves.

ALPETCO REPRESENTATIVE:

Let's try and keep this in perspective. We are going to go out and raise 2-1/2 billion dollars worth of financing. The lenders under these loan agreements are going to want to have some assurance that the debt's going to get repaid. People who we are going to sell the equity to want to be assured they are going to get a return on that equity. Now the only thing that really could happen, once they put up the money, is that the crude oil is available so that it can be processed, sold and the profits made. And I think for any types of these financing, everyone that I alluded to in my remarks, the raw material has been first, and the most key ingredient --

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you have to have the economic viability, the raw materials and the take of the product.

It's a three legged stool. You take away any one of those assurances and the stool falls down. So before anybody goes into this type of agreement on financing, they are going to have to understand that there is enough material there you can run through the plant and make the product of which the profit is going to service the debt. And so we were hopeful and we have been very hard on ALPETCO and we've lost. We wanted a 100% of the royalty oil out of Prudhoe Bay but we understood that that had already been committed and we wanted 100% of the other royalty oil because, as once again, there is no guarantee that the State can deliver oil. All you can deliver is what you get and we want to make sure for the financial viability of that project that at least you get 150,000 barrels a day of crude. Because I tell you when we shift the other way the lenders are going to say to us but how do we know we are going to get a sufficient supply of crude to be able to serve--you know, to run this refinery. Really, everything we've said is based on our supply of crude and that's really the foundation of where we start. We've got to have that supply of crude.

CHAIRMAN MILES:

Some of that is undiscovered yet.

UNIDENTIFIED SPEAKER:

That's right.

CHAIRMAN MILES:

Then your--that doesn't really--it obviously doesn't cause the financial people too much of a problem.

UNIDENTIFIED SPEAKER:

What undiscovered? Well, to the extent it continues to be discovered it will be beneficial to us. Right now the reserves that we've heard about seem to be in sufficient supply.

CHAIRMAN MILES:

Yeah, I think we all expect more oil but it is a certain, a little bit riskier than taking 150,000 known (indisc)

UNIDENTIFIED SPEAKER:

It gives us more assurance however than not having any.

UNIDENTIFIED SPEAKER:

Okay.

UNIDENTIFIED SPEAKER:

The more assurances that we can have, the better off we are.

CHAIRMAN MILES: Mr. Chatterton.

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MR. CHATTERTON:

Thank you Mr. Chairman. I apparently need a little bit of clarification on an obvious misconception that I have. I believe that I heard you Mr. Lopp say that the project can be financed given its economic viability. I can understand that and I heard you, Mr. Paynter, say that subject to a satisfactory credit agreement why you could support it. Now, that's what I heard. Now, have I miscontrued this? You have not given this your stamp of financial approval yet? Is that correct?

MR. PAYNTER:

No, we haven't given our stamp of approval based on the assumptions that I made in my remarks and I think just reiterated.

UNIDENTIFIED SPEAKER:

And if I can talk to..........what I said......

MR. HONIG:

This is Mr. Paynter ....

UNIDENTIFIED SPEAKER:

Oh, I'm sorry. That's okay. I apologize.

MR. PAYNTER:

We, of course, on the short term side look to the long term take-out and if they are satisfied, if they are able to sell to long term investors and long term lenders the note, the equity, the wherewithall then the commercial banking side of this is taken out.

UNIDENTIFIED SPEAKER:

Okay. Together with all these ifs why everythings fine.

UNIDENTIFIED SPEAKER:

That's right.

(Indisc.-interrupted)

CHAIRMAN MILES:

Mr. Chatterton.

MR. CHAT CHATTERTON:

Thank you. One question to Mr. Norris that may sound a little bit not connected with the subject dependent upon the response. Mr. Norris, your parent company is Haliburton (ph). To your knowledge

is any division or subsidiary of Haliburton (ph) engaged in the exploration for oil, production of oil and gas?

MR. NORRIS:

No, sir.

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

CHAIRMAN MILES:

There is a clause in the contract 2.6 Delivery of TAPS Fill by Seller, which essentially says that the State will supply trans-Alaska system pipeline fill and storage tank bottom requirements and that the State won't get paid till the termination of the contract. Twenty-seven years down the pike. How much oil is that--what actually is--what is pipeline fill and why shouldn't we get paid for 27 years? How much is it?

UNIDENTIFIED SPEAKER:

Well--this is a product (cough-indisc) our negotiations and we wanted the point of delivery to be Valdez and the State of Alaska wanted the point of delivery to be at the other end of the crude oil pipeline because they did not want to be a shipper. And all of our arguments have been for the delivery to be at Valdez. So in exchange for our agreeing to take the delivery at LACT Meter I the State agreed we could pay for the line fill at the end of the contract period or if upon termination immediately preceding termination.

CHAIRMAN MILES:

How much is that?

UNIDENTIFIED SPEAKER:

It's about -- well it's 85% of 1/8 of--in dollars it's about 9 million dollars.

UNIDENTIFIED SPEAKER:

But by the time it's ultimately paid for it will be paid for in the value of the oil at that time so if oil is $20 a barrel then it will be paid for at the rate of $20 a barrel (indisc.-interrupted)

CHAIRMAN MILES:

By unaminous consent we certainly appreciate the presentation....

(End of Meeting)

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Tuesday

2. Joe Moore - Bonner & Moore

A review of their report. Added comment was that ALPETCO was:

- Most responsive to State's needs.

- Had expended the most money in its efforts to secure the contract.

- Management had improved as a result of negotiations.

Questions and Answers revolved around the following topics:

- Alaska Disadvantage: Will value added concept diminish the Alaska disadvantage?

- Profitability: Petrochemical project vs. refinery.

- Preferable Location: Alaska over West Coast

- Japanese Interest: Unstable Middle East supply; Outmoded plants.

3. Administration - Bob LeResche and Fred Boness

Bob LeResche gave a brief summary of what has transpired recently to lead up to the current contract along the lines outlined in the attached memo from Connie Barlow to the commissioner.

He added that the ALPETCO contract was the"best possible deal we could put together for the State", and that it was infinitely better than to continue to take our royalty oil share in value. He said an opportunity would not represent itself again to sell our royalty oil so favorably.

He maintained that what risks existed were minimal, and that the Administration's burdens connect with the contract were confined to:

- monitoring the contract
- site selection
- some added accounting work
- litigating storage right question
- permitting process
- measuring and testing of the crude
- enforcing local hire provisions.

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Questions and Answers dealt with:

- Commitment of other royalty oil - 2.3 and 2.4 - and the ability of Prudhoe Bay to provide 150,000 b/d upon initiation of project start-up.

- Article XXII - "Referendum" Provision: Before it can go before voters it must first pass the Royalty Board and the Legislature.

- Volume: Percentage vs. specific amount. LeResche said it was a percentage, which differs from what Rep. Miles maintains.

- Extentions under Article X: They are not cummulative; they are measured from effective date. Passed this interpretation on to Randy Berry.

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Alaska State Legislature

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TRANSCRIPT OF TESTIMONY OF

ROBERT E. LeRESCHE

March 14, 1978

BEFORE THE SPECIAL COMMITTEE OF THE LEGISLATURE ON ROYALTY OIL AND GAS

Committee:

Senators:	Representatives:
Mike Colletta	Chairman Bill Miles
Pat Rodey	Chat Chatterton
Bill Sumner	Joe McKinnon
John Sackett	Charlie Parr
Kay Poland	Al Osterback

CHAIRMAN MILES:

We will come back to order, Commissioner, are you ready?

COMMISSIONER LERESCHE:

Yes, sir. Shall we go, okay. Mr. Chairman and members of the committee, I'm not going to spend a lot of time today by way of background, nor am I going to go through the contract term by term, as certainly you could do that as well as we could on your own. What I would like to do is summarize the procedures that we followed over the past 8 or 9 months to arrive at where we are today and to discuss the general questions that we had to deal with in making these decisions.

UNIDENTIFIED SPEAKER:

Will you speak a little louder, Commissioner?

COMMISSIONER LERESCHE:

I can sure try. To discuss the general questions we had to deal with in making these decisions and why we came down where we did on them. First a brief summary of what's happened to

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us in the past 9 or 10 months, actually is what it is. I'll start before that time, however. In May of 1975, the Department of Natural Resources issued a general interest solicitation for Prudhoe gas or oil for export or for in-state processing. Essentially this was a canvassing of the industry to see what type of interest we had in our royalty oil and gas. We sent out more than 100 letters and got I'm not sure how many responses, but not a vast number of responses. Remember, this was '75, before completion of the pipeline. Most of these responses expressed an interest in purchasing gas or oil with no in-state processing requirements. There were several, however, who did express an interest in in-state processing. These were Golden Valley, to whom we've since made a sale as you know last year; Tesoro, which at that time was thinking of expanding their Kenai refinery; North Pole, with whom we are about to consummate the contract and then Alaska Petroleum Company, one of the four final bidders in this present contract; and Cook Oil, which was suffering at the time from Canadian crude cutbacks and wanted a large volume purchase for export to their, I think, Minnesota refinery.

Given those replies and given the uncertainties of tariffs, oil pricing, etcetera, we let the matter sit for the next two years roughly. That was about a year ago. And you recall better then I do probably the events of last spring. We did approve a sale to Golden Valley. Meanwhile, both North Pole and Alaska Petroleum were putting some significant pressure on us to get on with consideration of the large volume sale. And perhaps more important, a group composed ironically of one of the present venturers was trying to force us and the legislature to make a very quick sale of Prudhoe royalty oil in order to avoid possible jurisdiction by the Federal Energy Administration. At that time they were arguing, if we didn't sell then we'd never get to take our oil in kind. As you recall, we got an opinion out of F.E.A. which made us all comfortable with our position and the fact that we can take in-kind in the future. So that is obviated. Perhaps the most important event that occurred last year was your passage of the amendments to the royalty board statute. These were very significant in that they changed the presumption under which the executive branch has to operate. From the date of passage of that we could not continue to take in-value until we considered all the alternatives -- until we'd made a finding that taking in-value was in fact preferable to the broad public interest to take in-kind. Now we took this mandate very seriously. However, there were two possible approaches. One would have been to sort of take an academic look at the whole thing, consider the problems of doing business in Alaska, consider refinery and petrochemical capacities and just conclude academically, if you will, that we might as well continue to take in-value. We did not choose

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that alternative.

The second alternative was to do what we did. And this is to lure the private sector into very significant considerations of markets and of possible projects, to lure them into doing that as part of proposals for our royalty oil. We felt that only through the private sector, through private industry look at markets and projects, could we get a proper feasibility study for an in-kind taking and sale of the royalty oil. So at that time we issued a formal solicitation for a large volume sale of Prudhoe Bay crude. Concurrently, the Royalty Board adopted 8 policies after hearing from some of you in testimony -- taking testimony from the Governor and others, and we adopted policies regarding price preference for in-state use and things like that. We then told the firms that received the solicitation that we would make decisions based on these policies. Our first deadline for preliminary proposals was August 1st, 1977. At that time we received 10 responses, some of which involved expenditures of several hundred thousand dollars at the outset for preliminary feasibility studies. We considered these very carefully and established a date in October whereby we wanted final concept proposals which would include draft contracts. After August 1st I sent out another letter to all legislators and interested parties throughout the state, discussing in some detail the issues as we saw them that were growing or evolving in this sale. This included a discussion of eleven objectives and a statement of how we proposed to carry out these objectives and a request for your comments on those. The objectives included volume -- that is as that time we said we would not sell more than 90% from the Prudhoe field; a policy, or an objective, that we did not wish to deliver crude before a facility was in place; an objective that we would favor the highest value added, all else being equal in the product state; an objective that we favor the largest facility possible within the constraints of optimized project economics; objectives regarding price; environmental controls, citing penalties and terminations under the contract; the role of the state in advocating permits etcetera; resident and minority hire objectives and in-state sales and prices of in-state products.

After the comment period, we proceeded with trying to negotiate all these objectives into the contract. We also sent the original 10 bidders detailed critiques of their proposals, comparing them with these objectives and clarified certain things such as volume and other things and outlined requests for the final October submissions. As a result of that, we came down to the four proposals. Municipal Utility Systems, which is one of the first respondents, withdrew. Tesoro withdrew. Pacific Resources withdrew, the Board rejected Energy Resources Incorporated of Salt Lake and Commercial Realty of Los Angeles for insignificant or inadequate final proposals. Following this -- we're down to the four proposals. We discussed these in hearings with Chairman

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Miles' committee and then proceeded for the following three months into intensive negotiations which resulted, as you know, about in the middle of February with our choosing ALPETCO as the best possible deal that we could put together for this state after all this time in light of real circumstances. We also concluded unequivocally that the ALPETCO contract before you now was infinitely better than a continuing to take in-value over the long term.

Now I'll just step back from that a little bit and mention briefly what the ideal contract would be. That is the ideal contract in the ideal world. The ideal contract maybe in the economists' world. I think we have the ideal contract in the real world, but what we started out to get was something different. That ideal contract under circumstances which certainly do not exist today would have been a contract with one of the major oil companies, or chemical companies, with an absolute commitment to build this facility with liquidated damages negotiated in. I'm not afraid to say we're unable to get that given all the world conditions that you've heard about for the last two days. It became clear that this was impossible. Royalty oil is expensive oil. There's no cut rate royalty oil under our pricing policy. Furthermore, the price is still undetermined, although it's much more determined than it was two years ago. The volumes that will be available are still undetermined, even with the option clause. Further, there is this theoretical disadvantage of doing business like this in Alaska, which is something else we had to take into consideration. The alternative to this ideal contract, and I think the best alternative in the real world, is a contract such as we've negotiated. This is a contract which minimizes the risks to the state and puts maximum incentives on the buyer, the private entity with which we want the state to contract, puts maximum incentives on them to make the project work for the benefit of not only their own pocketbooks, but all the people of the state. With that in mind I will just underscore what all of you know, the critical term in this contract is the performance term, Article X in which ALPETCO promises what they'll do, promises what they'll expend and promises what incentives they have. That, together with the security terms, does in fact leave the state virtually riskless and gives ALPETCO the greatest incentives that we could derive. To simplify -- ALPETCO's going to spend at least 10 million dollars over the next 18 months. They have to or the contract will be summarily cancelled. No one -- least of all the firm made up of listed firms is going to throw away 10 million bucks. They want it to fly as much or more than we do. If they don't get financing after this best effort, we get the oil back -- we've never lost it in fact by that time, we're left riskless. But basically we've negotiated that some

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

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

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

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

CHAIRMAN MILES:

Isn't that a Catch-22 though Commissioner?

COMMISSIONER LERESCHE:

No.

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CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

I don't follow that,Bill?

CHAIRMAN MILES:

Well I don't either.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Go ahead, we'll get back to that.

COMMISSIONER LERESCHE:

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

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

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

SENATOR SUMNER:

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

COMMISSIONER LERESCHE:

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

SENATOR SUMNER:

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

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

ly

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

SENATOR SUMNER:

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

MR. BONESS:

No, definitely not.

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SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

Lease sales? I don't see any connection.

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

Under 2.4, yes.

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

There's an express exemption for Tesoro.

SENATOR COLLETTA:

(Indisc. - simultaneous speech).

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COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

No.

SENATOR COLLETTA:

2.4 is inclusive of all state interests in production?

COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

Thank you.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yes.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

No.

CHAIRMAN MILES:

Why not?

COMMISSIONER LERESCHE:

Didn't feel any need to.

CHAIRMAN MILES:

Did you review royalty oil contracts from other states?

COMMISSIONER LERESCHE:

I assume that the attorneys did.

CHAIRMAN MILES

Which ones?

MR. BONESS:

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

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

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COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

This is above the weighted average price.

CHAIRMAN MILES:

How much?

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COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Well, okay.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

But he can't put a price on it?

COMMISSIONER LERESCHE:

No, because it's a probability judgment.

CHAIRMAN MILES:

Chat do you want to follow on that?

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

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

MR. CHATTERTON:

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

CHAIRMAN MILES:

Go ahead.

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

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

COMMISSIONER LERESCHE:

That's correct.

MR. PARR:

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

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COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

No. Okay.

MR. PARR:

No question about it.

COMMISSIONER LERESCHE:

Okay, I guess I understand that.

AGO 545564

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yeah, they approved the contract.

CHAIRMAN MILES:

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

AGO 545565

COMMISSIONER LERESCHE:

They made five or six specific findings.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

No other oil?

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

We have written approval of the Board.

AGO 545566

CHAIRMAN MILES:

Is that right?

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

They speak to this contract.

CHAIRMAN MILES:

Which one?

COMMISSIONER LERESCHE:

This one.

CHAIRMAN MILES:

Which resolution?

COMMISSIONER LERESCHE:

All of them.

CHAIRMAN MILES

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

COMMISSIONER LERESCHE:

Okay.

CHAIRMAN MILES:

We've got a legal opinion that says that.

MR. BONESS:

We haven't had the benefit of that opinion.

AGO 545567

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Yeah. I just got it yesterday, myself.

CHAIRMAN MILES:

Joe.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

Using royalty oil, yes.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

Not a veto, a chance to meet the price.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

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

AGO 545568

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

That's right.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

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

COMMISSIONER LERESCHE:

Yeah.

MR. PARR:

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

COMMISSIONER LERESCHE:

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

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MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR.PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

Thank you.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

AGO 545570

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

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CHAIRMAN MILES:

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

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

So ALPETCO gets 150,000 barrels?

COMMISSIONER LERESCHE:

If we have it.

CHAIRMAN MILES:

Yeah.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

Right. Okay.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Metaphysical.

CHAIRMAN MILES:

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

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the fox right in the chicken coop.

SENATOR SUMNER:

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

CHAIRMAN MILES:

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

SENATOR SUMNER:

But this wouldn't do it here?

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

(Indisc.)

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MR. CHATTERTON:

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

UNIDENTIFIED SPEAKER:

Right.

MR. CHATTERTON:

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

MR. BONESS:

May I interrupt just for a second?

MR. CHATTERTON:

Yes.

MR. BONESS:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

MR. CHATTERTON

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

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MR. BONESS:

Okay.

MR. CHATTERTON:

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

MR. BONESS:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

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

MR. CHATTERTON:

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

MR. BONESS:

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

MR. CHATTERTON:

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

MR. BONESS:

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

MR. CHATTERTON:

Well let me interrupt, if I may --

MR. BONESS:

Okay.

MR. CHATTERTON:

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

MR. BONESS:

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

AGO 545576

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

MR. CHATTERTON:

We have some unknowns then?

MR. BONESS:

That's right. There are some unknowns.

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

MR. CHATTERTON:

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

UNIDENTIFIED SPEAKER:

He confused me.

COMMISSIONER LERESCHE:

He left out 2/3's of it.

AGO 545577

CHAIRMAN MILES:

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

(Off Record)

(On Record)

CHAIRMAN MILES:

Questions.

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

MR. HONIG:

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

CHAIRMAN MILES:

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

AGO 545578

MR. HONIG:

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

CHAIRMAN MILES:

Might we get a copy of those expenditures?

MR. HONIG:

Yes, I'm sure.

COMMISSIONER LERESCHE:

They just want to write off Henry. (Laughter)

MR. HONIG:

We've already done that.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

AGO 545579

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

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

SENATOR SUMNER:

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

CHAIRMAN MILES:

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

MR. BONESS:

Okay, thank you very much Mr. Chairman.

COMMISSIONER LERESCHE:

Thank you, Mr. Chairman.

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

AGO 545580

Lipton

3/15/78

Observations:

① advantages to Alaska
Basis for ind. establishment / development.

③ Prospects of Success
Disposition of chem prod on W.C
is a reasonable assumption - a
potential mkt

Foreign Mkt - the most elusive and
difficult to predict - the areas
from which it can be
supplied "look well as
much more attractive
than Alaska"
Incentives for investments in
the Middle East -
- Transp. disadvantage
- Capital "
- Assured supply
} not because of
political thrust to develop an
ind. profile for reasons difficult
to platform - Impt psychological
urge to assume a pivotal
political role - not just look

AGO 545581 +

the role but act it
Export mkts will get served out of exportable supply, i.e., Middle East

(2) Risks to Alaska
If project can come to fruition, but (3) becomes a reality then what?

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

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

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

AGO 545582

defering the decision.

Income tax based on in-state

[Multi national]

formula. It would not generate much in income taxes

Comment

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

Questions:

Chatterton: Risk – getting Less – Yes! (the legislature) Should we take a risk with the people's money or not – Yes!

Parr: Main benefit – Breakthrough? Yes!
What are the obsolete plants in Japan with a modern plants – old plants an advantage rather than liability in many cases.

AGO 545583

→ Is the AK disadvantage outweighed by assured supply? Question-able!
We would be fighting the export market, which is now being increasingly determined (price) by Middle East

Miles: Future Reserves?
another risk! May be far more attractive in the mid/late 80s — assured supply vs. "alaska disadvantage"!

Pricing: We are being asked to make the same commitment as far as timing is concerned as is ALPETCO
If the state thinks PB is it, maybe the time is ripe to make that commitment now before too much is gone. If the State feels more secure in future reserves maybe we can wait in committing ourselves.

AGO 545584

(and for how long?

Hackney: Would the sky fall in if we waited?
The sky will not fall by delaying the contract. Urgency is abundant availability now which will decline.
A yrs or two will not be tragic; but we are turning our back on something that came to us in good faith!

Chatterton: If Option existed where would you locate project? at Valdez or W.C. of the US?
W.C. absolutely!

Later commitment better than earlier commitment!

Miles: Sands willing to offer more than AK!
They will offer over and above. (150M + (50M)
150M to process - 50M free of all strings).

AGO 545585

Stability of supply looses its attractiveness. Contradicts Tydings!

Parr: What are the risks?

Risks: Contract will collapse, most likely went.
Venture after venture fails
What is our credibility
- During time frame in contract - not too bad
- after initiation first 5 yrs will be difficult, and State will ~~be~~ feel obligated to do something not required by contract.
State will not allow it to flounder because of a lack of cash flow.

Royalty crude contract should not be conditioned on what State wants to do with its gas

AGO 545586

Wednesday

4. Milton Lipton and Dick Kilgore

Mr Lipton made his comments in the form of observations.

1. advantages to Alaska

-- Successful implementation of contract serves as a basis for industrial development

2. Prospects of Success

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

— However, the foreign market is most difficult to predict. other areas from which petrochemicals can be supplied "look ever so much more attractive than Alaska."

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

AGO 545587 +

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

AGO 545588

Alaska State Legislature

POUCH Y, STATE CAPITO
JUNEAU, ALASKA 9981
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TRANSCRIPT OF TESTIMONY OF

MILTON LIPTON

March 15, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:	Representatives:
Chairman Mike Colletta	Chairman Bill Miles
Pat Rodey	Chat Chatterton
Bill Sumner	Joe McKinnon
John Sackett	Charlie Parr
Kay Poland	Al Osterback

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

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back.

MR. LIPTON:

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

You just come on up.

MR. LIPTON:

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

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

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

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

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

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

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

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petro-chemical capacity in the Middle East itself.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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CHAIRMAN MILES:

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

MR. CHATTERTON:

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

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

MR. LIPTON:

There is a risk. There surely is a risk.

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Okay, fine. Fine. Thank you.

MR. PARR:

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

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MR. LIPTON:

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

MR. PARR:

Okay.

MR. LIPTON:

That's it.

MR. PARR:

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

MR. LIPTON:

For a specific market. For a specific market.

MR. PARR:

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

MR. LIPTON:

Increasingly, yes.

MR. PARR:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

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

AGO 545599

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

CHAIRMAN MILES:

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

AGO 545600

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

AGO 545601

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

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

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

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

CHAIRMAN MILES:

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

AGO 545602

MR. LIPTON:

Absolutely.

CHAIRMAN MILES:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

MR. LIPTON:

For what? I'm sorry.

MR. OSTERBACK:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

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

AGO 545603

MR. LIPTON:

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

MR. OSTERBACK:

Thank you, Mr. Chairman.

SENATOR HACKNEY:

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

MR. LIPTON:

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

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

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

CHAIRMAN MILES:

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

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

AGO 545604

MR. LIPTON:

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

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

MR. CHATTERTON:

Thank you, Mr. Chairman.

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

Of course, of course. Surely, surely.

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MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

MR. MCKINNON:

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

MR. LIPTON:

Yes.

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MR. MCKINNON:

Another (indisc.)

MR. LIPTON:

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

MR. MCKINNON:

Is that only for a deficiency out of Prudhoe?

MR. LIPTON:

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

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

MR. MCKINNON:

Yes, that's the way I interpret it.

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

I don't believe it does.

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MR. MCKINNON:

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

MR. LIPTON:

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

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

MR. MCKINNON:

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

MR. LIPTON:

Yes.

CHAIRMAN MILES:

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

MR. LIPTON:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

They tended to be, yes. Very definitely.

MR. PARR:

Everybody has seen the possibility all at once?

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

AGO 545610

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

Well, maybe commercial decisions and government-political decisions?

MR. PARR:

Possibly.

Thank you, Mr. Chairman.

MR. LIPTON:

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

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

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

CHAIRMAN MILES:

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

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profile point that you made.

MR. LIPTON:

On the petrochemical investment there?

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

I'm sorry, I misunderstood you.

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

CHAIRMAN MILES:

Thank you.

MR. CHATTERTON:

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

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MR. LIPTON:

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

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

SENATOR HACKNEY:

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

MR. LIPTON:

Remember what I said?

SENATOR HACKNEY:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

Yes. Sure.

MR. CHATTERTON:

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

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

MR. LIPTON:

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

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

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MR. CHATTERTON:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

CHAIRMAN MILES:

Thank you very much.

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

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Present:

Osterbock

Greening

Miles

Parr

Chatterton

3/16/76

Battelle Northwest Presentation

Tressing

AGO 545621

1. What is the likelihood that the ALPETCO project will be commercially viable?

   (a) Comment on the "Alaska disadvantage" and on how ALPETCO might overcome it?

   (b) Comment on the realism of ALPETCO's marketing plans for Japan and for the U. S. West Coast.

2. Is it possible or likely ALPETCO could get its project financed without an overwhelming assurance of its commercial feasibility?

3. What would happen if the ALPETCO facility were financed and built, and after its completion it were to be unprofitable? What would be the consequences for ALPETCO's sponsors, for the bondholders, for the employees, for the community in which the plant was located, and for the state?

4. If ALPETCO were to encounter difficulties either in financing the project or in operating it profitably, what other assistance, if any, would ALPETCO be likely to ask from the state, apart from a discount on crude oil prices? What would be the costs, risks or other implications for the state from these measures?

5. What will be the likely impact of the ALPETCO project on the West Coast oil market and on the value of Alaska crude oil generally, both before and after the proposed facility goes on stream?

6. Comment on sections 2.3 and 2.4 of the contract, specifically the option to buy non-Prudhoe royalty oil.

7. Comment on the procedures by which the Commissioner of Natural Resources and the Royalty Board decided to negotiate this contract.

8. How can the Legislature best resolve the factual, legal, analytical and policy questions presented by this contract?

AGO 545622

Tussing

3+M See Report

ALPETCO CRUDE OIL RESALE SCENARIO, 1980

September 1977 Data
(Bonner and Moore)

Destination:	Alaska	Cherry Point	California	Gulf Coast	Total
Volume(mb/d)	82.5	452.1		178.8	713.3

	Alaska	Cherry Point	California	Gulf Coast	Weighted Average
Value at destination	12.50	13.30	13.38	13.77	13.35
less transportation from Valdez	(-)	(.60)	(.82)	(3.05)	(1.21)
Value at Valdez	12.50	12.70	12.56	10.72	12.13

	Alaska	Cherry Point	California	Gulf Coast	Total
Arco volume (mb/d)		143.0			143.0
Exxon volume (mb/d)	2.9	139.0			141.9
Sohio volume (mb/d)	74.4	141.6		167.5	383.5
Total Volume (mb/d)	82.5	423.6		178.8	713.3

	Alaska	Cherry Point	California	Gulf Coast	Total	Average Valdez Price
1980 distribution (Bonner and Moore)	73.0	300.0	302.0	525.0	1200.0	
Assume Alaska and West Coast Sales Distributed among Companies in Same Proportion as 1977:						
Arco volume (mb/d)		190.4		49.6	240.0	12.23
Exxon volume (mb/d)	2.6	185.1		52.3	240.0	12.21
Sohio volume (mb/d)	65.8	188.5		390.1	644.4	11.46
Total volume (mb/d)	73.0	602.0		525.0	1200.0	11.79

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

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(1) ALPETCO would lose money marketing this crude oil at the U.S. Gulf. (Cost \$11.79 + transport \$3.05 = \$14.84; value at Gulf cost is only \$12.77.)

(2) Therefore ALPETCO must make room for this crude on the West Coast. (Cost \$11.79 + transport average 71 cents = \$12.50; value is \$13.34; potential profit 84 cents.)

(3) But ALPETCO has to compete the market away from other producers. 150 mb/d is a very large part of a total market of 602 mb/d. Prices will have to come down.

(4) ALPETCO is willing to resell its oil at 2 percent over cost. Therefore it will accept a Valdez price of \$12.03. Suppose it is able to make room for all 150 mb/d at this price.

(5) SOHIO with an average Valdez cost of \$11.46 could easily defend its market share. Competition between ALPETCO, SOHIO and California producers would tend to drive West Coast prices down to ALPETCO's minimum price \$12.03 plus tanker charges; Alaska prices would likely fall by the same amount to \$11.90.

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

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

The new priced ALPETCO would be \$11.48.

$e = \frac{dQ}{dP} \cdot \frac{P}{q}$

$e = -1$

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

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

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

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

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

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April 7
reasonable depth

5:25 Channel 2 or 3

half hour

Alaska State Legislature

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

TRANSCRIPT OF TESTIMONY OF

DR. ARLON TUSSING

March 16, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:	Representatives:
Chairman Mike Colletta	Chairman Bill Miles
Pat Rodey	Chat Chatterton
Bill Sumner	Joe McKinnon
John Sackett	Charlie Parr
Kay Poland	Al Osterback

DR. TUSSING:

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

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

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

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

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

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

CHAIRMAN MILES:

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

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

DR. TUSSING:

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

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

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

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

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

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

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

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into this?

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

DR. TUSSING:

Because there's a surplus of oil.

CHAIRMAN MILES:

Simply because of this?

DR. TUSSING:

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

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

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman.

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

DR. TUSSING:

Yes. Surely.

MR. CHATTERTON:

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

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

DR. TUSSING:

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

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

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

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

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

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

MR. GRUENING:

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

DR. TUSSING:

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

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

MR. GRUENING:

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

DR. TUSSING:

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

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

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

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

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

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UNIDENTIFIED SPEAKER:

You've been there before.

DR. TUSSING:

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

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

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

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

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

UNIDENTIFIED SPEAKER:

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

DR. TUSSING:

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

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

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

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

UNIDENTIFIED SPEAKER:

I think we should just keep going.

DR. TUSSING:

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

UNIDENTIFIED SPEAKER:

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

DR. TUSSING:

Yes.

(FIVE-MINUTE BREAK)

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DR. TUSSING:

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

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

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

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

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

CHAIRMAN MILES:

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

DR. TUSSING:

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

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

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

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

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

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

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

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

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

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

MR. PARR:

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

DR. TUSSING:

Yes....

MR. PARR:

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

DR. TUSSING:

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

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

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

MR. PARR:

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

DR. TUSSING:

Well, that's the most likely.

MR. PARR:

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

DR. TUSSING:

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

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

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

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

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

CHAIRMAN MILES:

Anyone want to comment on that?

DR. TUSSING:

Well, maybe that's unfair....

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CHAIRMAN MILES:

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

DR. TUSSING:

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

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

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

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

Come-By-Chance

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

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

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

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

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

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

CHAIRMAN MILES:

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

DR. TUSSING:

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

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

CHAIRMAN MILES:

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

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DR. TUSSING:

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

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

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

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

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

MR. PARR:

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

DR. TUSSING:

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

MR. PARR:

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

DR. TUSSING:

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

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it gets only the in-value price.

MR. PARR:

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

DR. TUSSING:

Well....

MR. PARR:

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

DR. TUSSING:

Well, demand is not outstripping supply now.

MR. PARR:

This year, this year.

DR. TUSSING:

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

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

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

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/Whereupon the tape recorder apparently ran out of tape/

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

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

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

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

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

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

CHAIRMAN MILES:

Are there any questions for Dr. Tussing?

Thank you very much. It was exciting and enlightening.

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Saturday 3/18/78

Teleconferencing

① Take testimony from witnesses in Juneau

② One witness from listeners in Anch, Fbks, Nome

- Rice + Brennan's testimony (Trustees of Alaska) in the record
- Tussing to Royalty Board testimony

Hearing -
Risk involved and
Rewards
Subsidies

Subsidies
Reduced Price
70% Prov.
90% Prov.

Risks (+ Rewards)
Near term Risks
1. Flood CA with crude oil (Tussing)

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Scenario remote
2. Unable to put project together with 18 mos.

Near Term Rewards
1. Employment
2. Construction

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

Rewards
Jobs
Construction
Investment
Profits of Endowment Trust

All we want is "the opportunity to try".

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Miles: Subsidy Question:
- Line fill requirements 9MM
- Price Changes/Reduction

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

- Joe's insistence, — a strength rather than weakness

Miles: Nevertheless, the reduction is a real possibility

Chatterton: At what time can ALPETCO take the [illegible] under 10.2(d) and Financing Question: Not just capability to borrow the 1.5 bln but a commitment.

Miles: Cost of facility

Hovig: Rough estimate 2.5 billion
incl offsite
dock
utility

Miles: Why is it not mentioned in the contract?

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

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

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

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Honig: Pg 21 – "Core" Refinery of Presentation
includes feeding
the aromatics
Plants + Feed
Separation Plant.
It will have to
serve more than
the 30 M/ brls.

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

Miller: What can you do that Alyeska
did not do to assure
max AK employment.

Honig: ① 34,000 reasons – the natives
in this venture.

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

AGO 545662

Testimony

FBks — 2

Nome —

Anc — 1

FBks: Witnesses

① Dr Wm. Wood — Former U of A Pres.
applaud the proposal
ALPETCO proposal for people
of alaska.
jobs —

② Mr Terry ~~Rauber~~ Pelozer
Public Input by public during
negotiations

2.2 } to be included in NPR
2.4

4.2 } Commitment to 2.5 blm
4.3

2.2.2 add infinitum

4.4 endowment — future

5, 6, 7, 8 + 9 } ALPETCO Capitilizing at
13 } alaska's expense

10.3

25.2

AGO 545663

anchorage:
Jerry McCutcheon

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

Issues not addressed by Royalty Bd.

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

AGO 545664

advise Mike Miller

Doscher & Daugherty report not the final report — certain sections will be strengthened

—

Contract still under neg.
Reliable source at the RB hearing yesterday
Call the adm. and ask them!

Henry Pratt —
— No scare tactics have been used so far
— Participation has been high
— Legislature can be first to have the honor to lay the base for industrial development.

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

AGO 545665

3/20/78

Questions to ask ALPETCO people

(1) Barbour Oil
- Current production ?
- Pricing tier ?
- Location of production ?

Battelle

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

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

Battelle

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

AGO 545666

Battelle

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

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

(4) Has contract been physically been signed?

Rogers: Yes

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

Rogers: Unclear

AGO 545667

Kathy Chandler
Eddy Rogers - Hank Pratt 3/20/78

Rep: McK
McAllister - Not affiliated with ALPETCO

Miles: Where in contract that 150M has to be processed
R : No requirement

McK: If refinery would only use 120,000 b/d, would we be obligated to furnish 150,000
R : Yes, but would probably not call on it unless needed for storage
Unlikely that they will ever take interim oil

Miles; 90% option - Reaffirmed earlier testimony that their concern
R is that a lower price would "destroy a competitive price"

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

Kay Brown → "lower adjusted price"

— all conditions attached to a sale would apply (refinery on Homer Spit)

AGO 545668

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

Chat's scenario

- 30M b/d refinery capacity
- Ltr of credit
- 30M b/d processed
- 120M shipped south

R 10.2

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

R obligatory (tape 1810 F)

R 10.2 not considered a breach or default

Chatterton: If you do not meet benchmarks in 10.2 we can terminate - unequivocally?

R Yes - In addition State can cancel under 4.2 if petrochemical facility has not been built.

AGO 545669

Concessions

Miles: ① Where did LeResche not give

90% – 85 + 5? %

90 – 90

90 – 70

② Point of Delivery Point

Valdez vs. P.S. #1

③ Charitable Foundation

4.4 definitional problem

affiliates

(?) 8.2 – in-kind vs in-value

Cost to ALPETCO

Miles: Article 12 – Commitment? To what extent?

Letter of Credit – Funds up to amts promised, issued by bank.

blank check up to the face amt of value.

AGO 545670

Thursday 3/23/78

Administration
Barnes + Bale Maynard

— Purchaser – Supplier Relationship Provision

— Whereas Clauses

— "Indirect beneficial shareholder"
Seatrain – not directly involved
– a second line corporate bond

Chairman Chatterton

— p 42 14.3 – whose language is that?

Fred Alpetco

Ch p 43 15.1, 2, 3 whose language

Fred a combination

AGO 545671

Chatterton: a mutually agreed

upon article

For: Yes!

Ch: p 32 10.2 (3) 18 mos prov.
not too diff to meet
that benchmark
Have they achieved
the step where they
can take the royalty
oil?

For: Yes

Ch: p 33 10.2 (5) 30 mos prov
commence construction
of facility –
It is conceivable at this
point
by definition I submit that
this would be a 30,000 b/d
refinery – a portion of
world scale petrochemical plant
– the royalty oil (150M)
– this is as far as ARPETCO
will go
– not go further
– If they take this position
and I refuse to meet
any further
benchmarks, how can

AGO 545672

the state terminate contract?

For: Yes
p14 - energy, aromatics, olefins, etc

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

Ch: under this scenario, ARCO says "I disagree and I see you in the courthouse" and furthermore I will not perform under the under conditions to

For: Contract will terminate under article 10

Ch: now lets talk about 14.3 - materiality of Breach No default has occurred where you suffer no economic loss.

AGO 545673

For: One of the purposes is that one of the material

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

Ch: - force majeure clause seems to bail them out - defense line is wide enough to drive sev. tanks through

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

Fr: Non-ability, to borrow money, is not grounds for force majeure.

Ch What about EIS or docking fac.

Fr: That's more likely to happen but not applicable since if they submit a EIS for 30M b/d ref. it is not in compliance with 10.2

Ch: You feel comfortable then?

AGO 545674

Fr: Yes

McK: Expend or commit to expend

Fr: Problem they had and which we recognized (listen to tape)

Fr: Inability to get financing to commit what you promised to do will not be covered under force majeure.

McKe: 30M of in-state funds — no requirement to process 150M
— No requirement to produce 30M either?

Fr: I can't shed any light on that
Struggled with language — we bumped into lot of problems anti-trust — this

AGO 545675

language is far as we
could go
It was our conclusion
that if the fac was
here and the mkt
was here, the incentive
would be there for
— I was unable to come
up with a solution

Miles — What about processing?
Candy!

Fr — If you build a fac you
have to put oil through
No banker would allow
them to ~~set~~ sit (11)
~~[illegible]~~ idle

M What about using another
feed stock rather than oil?

Fr Doubt that they could
get by without running
oil through that refinery
However, no prov. to
run 150 M b through
~~[illegible]~~ refinery; but
I just don't think it's

AGO 545676

economically viable!

Ch: 8.2 vs. last sentence of 8.1.1

Fr: "Settlement" in court suit rather than judicial determination!

Ch: What length of time is involved?

Fr: 2-3 yrs, maybe less!

Miles: Article 6 vs. 2.3 - quality -

Ch: Production decline after 1985 - Rather rapid!

ALPETCO - first refusal on all future royalty oil?

Fr:

Ch The possibility that new field could come on stream that would even keep up with the decline of PB is incomprehensible to me!

McK: Same terms + same conditions (22) AGO 545677

Homer Spit Refinery

Scenario ask of ALPETCO

Fr: Never contemplated this
Have to meet the/all
~~the~~ the conditions.

Miles What about reduction in the ALPETCO facility?

Fr: To prevent another fac coming on line with cheaper feedstock!
– Yes, it would probably be in alpetco's interest to take 2.3 option, even with strings attached, even if they have to shut down 1st fac. since they get oil cheaper.

Parr: How do you know that we are well protected – loopholes?

Fr: Looked at other contracts of this nature; and extensive review by lots of people
ALPETCO's review is also helpful as far as their benefit.

AGO 545678

Parr: 70% clause - involved?
leases with little "C" - reference
in contract

Miles: Future lease forms would
work advantageously for
State

Parr: Beaufort leases would
come under 70% prov.

AGO 545679

EXCERPT FROM THE TESTIMONY OF JOE MOORE

April 5, 1978

AGO 545680

CHAIRMAN MILES:

Joe, a couple of questions, I think, -- if you could put on your oil consultant hat for a moment. How serious is the possibility that the royalty oil contract will short circuit any gas, any possibilities of in-state gas process?

You seem to indicate that --

MR. MOORE:

Putting it in that sequence, I don't think it would make any difference.

That is if the royalty oil contract is approved and the process goes along, as I assume it will be scheduled to go along. I would estimate that a substantial chemical company, if they could be interested in the utilization of gas for a chemical plant -- I think that they would not consider the royalty oil contract as being inhibitive there. I think they would look at it as a certainty.

CHAIRMAN MILES:

Okay, that's what I don't understand. If there's going to be marketing problems of the two facilities; one facility is essentially substantially less expensive to build, it seems like there's going to be a problem downstream.

MR. MOORE:

Well I guess if you think about the ALPETCO cake as (Indiscernible) as ALPETCO has said, they're not committed to any particular product slate and in order for ALPETCO to build the plan on the scale that they have envisioned, that they have indicated that they would build, they have not built -- their investment schedule envisions building a big petrochemical plant. They could build something that would otherwise meet the state's criteria, having built something significant for a lot less -- say a billion and a half I think is their first cutoff point. Now what that really does, it ties them into building something pretty darn elaborate. (Indisc.) Now to build that petrochemical plant they have got to in some way market this product in a market which they participate. They have to penetrate a market that they're not involved in, that they're not in right now. I suppose that their strategy really would be that this penetration would be through some kind of joint venture. I don't know this, I'm just interpreting what I think I've heard ~~Hugh~~ Peter Spitz and Gordon Caine say, that they would be looking for people who are presently in that market but who would come in as some kind of a joint venture on the

AGO 545681

plan with ALPETCO. Now if that were the case, then a joint venture partner would be -- well there would be ARCO, there would be EXXON, it would be SHELL, it would be GULF, it would be CARBIDE, it would be MONSANTO (ph) or it would be DOW. Now I don't think any of those people would go into partners with ALPETCO.

CHAIRMAN MILES:

Where does that leave ALPETCO then? Insofar as proceeding with the contract.

MR. MOORE:

I think to proceed on the full scale that they envision, I think they have real problems as I have said in my report. They may proceed -- they may very well find that nitch that they can proceed on and I think it's fair to say that their thinking is probably pretty wide open on that point. But the project that was proposed originally by John Barbour which I think is the only really written version we have seen with the scope of what the ALPETCO project would be -- I think they can't do that. Now I'm not saying they can't do something, but I don't think they can do that.

CHAIRMAN MILES:

Well what do you envision them doing?

MR. MOORE:

Well it would be feasible for them to build a fuel refinery and a third stage to which they would start adding some petrochemical operations.

CHAIRMAN MILES:

Based on crude oil or --

MR. MOORE:

Yeah, crude oil. I mean let's just take -- forgetting the gas for just a moment, let's just take one of the scenarios which is most likely of success for ALPETCO. Well I think the first criteria will be that the most successful thing they can do would be something that would be simple. And the simplest thing they could do would be something that would be (1) essentially a fuels refinery, a core plant to start with. What's the next simplest thing that they could do? Well probably produce some (2) aromatics. What's the next simplest thing that they could do beyond that -- (3) a few specialty chemicals. Now you're building up to the point that can they at some point develop a position in the

market such that they could competitively go up against the real big companies and force their way into the (indisc.) market. Well with some financial substance behind them, the plant in place, they've got lots -- they've got maybe a chance for doing that. What I have felt was wrong with the plan that they originally proposed was that there was no way that they could go into that market with those big companies and succeed. That those companies would keep them out and in my report I pointed out that in the chemicals business, unlike the fuels business, market share is guarded very carefully by those people who are in the market. And they really fight for market sharing on a competitive basis. And they don't really in the fuel oil business. I mean a few of them do but, you know, fundamentally EXXON and ARCO aren't out fighting for fuel oil business. If somebody wants to sell fuel oil, undercut them $.10 a barrel, fine they'll do something else with their oil, they won't really fight them for it. But in the chemicals business, because of the high profit margin during the good times, they'll fight for their share of the market. And they fight by cutting the price. But ALPETCO is going to run against them. If they start trying to sell ethylene, they're going to run up against a situation where (a) they're unproven suppliers and where they're going to go to is being supplied to somewhere else. Now they're going to be able to woo them away from that alternate supplier either by cutting their price below the price at which their present supplier will cut price and they can't cut the price as low as their present supplier will cut price or they're going to have to (indisc.) say ALPETCO has a -- represents an assurance of future supply, which is better than their alternate supplier and furthermore that they will be willing to pay enough more for that future assured supply since there's the fact that their competitor's going to cut price more than ALPETCO can cut price, will still give them the incentive to come with ALPETCO. But ALPETCO will never be able to cut the price as low as EXXON will cut the price or as ARCO will cut the price or MONSANTO and so forth will cut the price, they just can't do it. So they've got to figure out another way to attract somebody to buy from them. And that's pretty hard to do. When somebody else will cut the price to whatever it takes to keep the business, it's hard to get away from it. And that's the fundamental problem they're going to have.

CHAIRMAN MILES:

Well I'm still unclear as to how that statement relates to what your report says. Liquids availability at the right price would likely require that the oil project be abandoned and converted to the use of NGL (ph). Either it's -- and maybe I'm just making this too black and white, but it seems to me it's going to short circuit NGL development or it's not. I don't get what the balance is or what the ratio is.

MR. MOORE:

Well I don't have a certain answer to the question either. I would say this though that if you had -- let's take ARCO, they're a big ethylene producer and they produce on the North Slope. Now if ARCO decides that it made sense to them to supply the West Coast ethylene market growth with gas liquids, I don't think that ALPETCO's -- the fact that ALPETCO is out there also, would deter them a moment. I think that they could figure that they could kick ALPETCO out of any situation that ALPETCO was in. They've got the financial muscle, the marketing muscle and everything else to do it. If it were the other way around, I think there would be a problem. I think the fundamental issue in the chemicals business is the -- not in the chemical business in general -- but the ethylene business, particularly, is that that is a very big company business. And pretty big companies have been forced out of that business because they didn't have the financial resources. And if you look at people who are in it now. It's nothing but the very largest corporations because it has gotten to require so much capital and willingness to absorb substantial downside risks under poor market conditions. It's just a game that small companies can't play.

CHAIRMAN MILES:

You're not answering my question.

MR. MOORE:

Alright, phrase it again.

CHAIRMAN MILES:

I'm trying to find out how approval of the ALPETCO contract will affect the development of gas or gas liquids in the state? Well that does seem contrary to what you said in your report.

MR. MOORE:

The report -- oh, okay I see what your problem is. If these were two separate activities (a) you had the ALPETCO contract you sign it then (b) you wanted to do something to develop the gas liquids thing. When you sign the ALPETCO contract you have not said that. What you have signed is a contract to develop a petrochemical complex. I think that is a very important understanding.

CHAIRMAN MILES:

Do you want to repeat that last one.

MR. MOORE:

Well ALPETCO has a guarantee it can build a petrochemical complex.

CHAIRMAN MILES:

I just want to make sure I heard you right.

MR. MOORE:

That's what their intention is. And that's what everybody hopes that they're able to do. But it could well turn out that the thing they -- if they put something together it may be something that does not involve a petrochemical complex initially. So that's the first point. You haven't necessarily said you're going to build a -- create a petrochemical complex by ALPETCO. And the second thing is that if you could find someone who is -- if you had a good deal on a gas liquids side, and you really were -- and you had made a policy decision that ALPETCO was the group that you were essentially cooperating with in this kind of development, then you probably would want to give them this favorable opportunity. Now if you did not choose to do that, if you said well, ALPETCO's on their own, you know, the state has no more relationship with them other than just having signed this contract guaranteeing them a supply of royalty crude and now we want to set up a -- want to entice a big chemical company to come into the state and use these gas liquids, I don't think the existence of the ALPETCO contract would deter per se would deter, you know, an ARCO or a DOW to come into here and looking at the gas liquids, if they were otherwise inclined to do so. I just don't think that the ALPETCO contract -- they would weigh it one way or the other.

CHAIRMAN MILES:

Okay. Let me put it this way then. If ALPETCO entered the contract and it's approved, does what it says it's going to do, 30,000 barrels of fuel and the rest in petrochemicals, would you recommend to a major client that they go in and develop a gas liquids facility?

MR. MOORE:

If I was sure that ALPETCO would do that?

CHAIRMAN MILES:

Yeah.

AGO 545685

MR. MOORE:

No, I wouldn't.

MR. CHATTERTON:

Is that because the market in other words is full even enough now, saturated enough now that one plant might break ~~in~~ but two would be doggone (indisc.)

MR. MOORE:

And so fundamentally I'd just repeat that I think that ALPETCO --I think it's unlikely that ALPETCO in their first realization and what their affect on the market is over the next two years or 18 months or whatever it is, I think it's unlikely that they will really be a factor in the ethylene market or the ability of a major present supplier to promote a new plant. I just don't think they'll be a factor.

MR. CHATTERTON:

If ALPETCO -- if there weren't the strings attached, why ALPETCO was trying to penetrate this market, why would they be in a much more competitive position to do so if the state's royalty share of the oil was transported to California to a petrochemical plant on the West Coast?

MR. MOORE:

Well I think the whole problem -- the point I'm trying to get across is that I see the biggest deterrent as being one that your logic in coming must be that ALPETCO -- you're going to try to keep them out of the market, regardless of their feed stocking, regardless (indisc. -- cough).

MR. CHATTERTON:

But whether it be Valdez, Kenai or the West Coast, that would be under the terms of the contract with the State of Alaska, but there is some other thing where ALPETCO could -- there is permissiveness in the contract where ALPETCO could knock anybody else out of the market.

MR. MOORE:

The contract, yeah, but not in the bank book.

MR. CHATTERTON:

But in the contract why it's permissive -- I mean presupposing they could get their feed stock at $.50 a barrel. They could do a pretty good job, (indisc.). Even if we gave them the oil?

MR. MOORE:

Well I'd say it's in the range of feasible alternatives. I

think that it doesn't help. I don't think that they are particularly helpful one way or the other.

MR. CHATTERTON:

I see, thank you.

MR. MOORE:

We have worked with so many projects where people have tried to break into the ethylene market, people double the size of ALPETCO or even some a little bit bigger and at some point it gets down to the fact that you've got to have lots of guts or your banker's got to have lots of guts to go ahead because there's so many ways that competitors can keep you out of that market and if they're bigger than you are and they want you out of the market at some point you come to a premise that no one you've ever dealt with before has been able to -- you know, they've all backed away. And they may back away for all sorts of reasons. They can't get the financing, they can't get the contracts, so on and so forth. That's just a really rough game.

MR. PARR:

You said something about this a little while ago and I'm afraid I didn't hear you as well as I'd like to. You were talking about in the lower 48 petrochemical plants based on gas liquids hadn't been able to compete whereas this state's position versus (indisc.--loud noise) because of amortization.

MR. MOORE:

Yes, amortization of the total costs.

MR. PARR:

Yeah, and you said that they could absorb, I guess, fluctuations in price, low prices for (indisc.) I wasn't really quite -- I know so little about economics in business that I'm embarrassed but nevertheless I didn't quite understand what it was you were saying. If I understood you right, let's say this plant that ALPETCO's going to have a 2-1/2 million dollar plant, this one might be say a billion dollars, they're both selling the same product, ethylene. Now how does the fact that there's a bigger investment than the ALPETCO plant, I mean assuming that it's one of (indisc.) lower 48 situation, it wouldn't be quite as true up here. But how does that fact that one of them costs twice as much today, help them?

AGO 545687

MR. MOORE:

Well, okay. The (indisc.) has two characteristics, one is that it produces a wider range of products and secondly is that of it'stotal cost, only half of that cost is variable.

MR. PARR:

Their bonded indebtedness or whatever kind it is.

MR. MOORE:

The (indisc. -- simultaneous speech) cost of that plant.

MR. PARR:

That's the same year in and year out (indisc. -- simultaneous speech)

MR. MOORE:

(Indisc. -- simultaneous speech) some costs. But the cash flow that's produced by the plant only has to account for half the total cost which is the feed stocks, utilities and labor support. So if I want to cut the price if I want to compete, you know, cut the price. I can cut my price 50% and still have net dollars coming in every day from the operation of this plant. Now sure, I'm not paying the bank off as fast. Maybe I'm not paying myself back as fast on some investments. But in terms of just the sheer money coming in for the product, less the money going out for the feed stock and the utilities, I can cut prices 50% and still make a positive cash flow.

MR. PARR:

That's if your bank will let you get by with that.

MR. MOORE:

That's right. And then, of course, for that reason, you don't see anybody getting a crude oil plant -- there is no crude oil plant in the word that's not operated by an oil company.

MR. PARR:

So they have (simultaneous speech). The guy that runs the gas liquids plant though doesn't mean they are in the same position, right. There's a higher percentage of his costs are the variables, the cost of the feed stock and so forth.

MR. MOORE:

It could be over-simplifying to say whether it's good or bad. Because I could say well the crude oil plant has more products, therefore it's diversified and therefore that's good. But if you're going into a virgin market, that's bad because you've got to sell so much stuff.

MR. PARR:

So if the price of ethylene is low and the price of something else is high at this time you have a chance to sort of balance it off.

MR. MOORE:

Well if you look at the Gulf Coast where you have all the petrochemical industry there, a crude oil plant that produces all of these byproducts, there's someplace for all of those products to go because there's some plant around there that takes all of these products. Now by contrast, if you look at Saudi Arabia, something you read about in the news, they're looking at several ethylene plants but they're all ethylene plants because there's no plant anywhere around that takes anything. So their marketing problem is very complex and they'd like to just produce one product if they can, based on one product. That's a lot better than selling two products. So in all cases they're looking at the simplest plant that they can come up with so they have the simplest marketing problems; the simplest transportation problems. And this is kind of the analogy that we followed in thinking that the ethylene plant is kind of the obvious one for Alaska because you really have a virgin market. You don't have an infrastructure of other plants around you. And you have to create all that at one time; that means more money, more loose ends you have to pull together.

MR. CHATTERTON:

Well following up on that Joe, suppose we okay the contract with ALPETCO and they go ahead, and they're starting a business -- they're trying to break into the market to produce the products (indisc.) And then if somebody did decide to go into the gas liquids plant, it's going to make ALPETCO's job perhaps even harder because they've got one more competitor who can produce perhaps more cheaply than they can.

MR. MOORE:

Well I think that's true. When you're thinking in terms of ALPETCO trying to build a major petrochemical plant but under the terms of their contract, they don't have to do that.

MR. CHATTERTON:

I understand that. This is just a hypothetical case. Under their contract they have to produce 35,000 barrels of crude (indisc.)

MR. MOORE:

(Indisc.) 100,000.

MR. CHATTERTON:

Billion and a half dollars in a certain period of time or else they lose their contract.

MR. MOORE:

Yes, and that's tough. That's pretty well -- if you really stuck it with that it would tie it to --

MR. CHATTERTON:

A billion and a half is more than you can justify on just producing an amount of fuel oil and gas so they'd have to do something with it or else ...

MR. MOORE:

And personally I think ALPETCO was dumb to have agreed to that. And I think that it is not in the state's interest to hold them to that even. If ALPETCO could come up and show that they had put together a deal for 700 million dollars, 600 million dollars at the end of 18 months, they reap the contract terms and it seems to me in equity that that is a significant affair -- discharge of their obligation. And I look at it, if I were in a position of having to decide whether -- what ALPETCO had done was in conjunction with what the intent of the state was when they started out this royalty oil thing, I'd be hard pressed to say that they could spend 600 million dollars or 700 million dollars on an oil processing facility, that there was anything wrong with that.

MR. CHATTERTON:

(Indisc.)

MR. MOORE:

Well, it is, 600 million dollars is a lot of money.

MR. CHATTERTON:

Not Alaskan terms.

AGO 545690

MR. MOORE:

In the refinery and petrochemical industry, it is. I don't

think and I'm not positive of this, but I don't believe that it has yet been grass roots project built for a billion dollars. And you talk about it so much that you almost think it's actually been done. I don't think it's ever been done.

CHAIRMAN MILES:

What's a grass roots project?

MR. MOORE:

Oh when you start off with nothing, just build it. I go out with the grass roots and I create a plant. That's what we call a grass roots plant.

CHAIRMAN MILES:

How do they get them built?

MR. MOORE:

Well they do but there hasn't been one built that big yet.

CHAIRMAN MILES:

They're built in stages.

MR. MOORE:

Well yeah, they're built in stages and also most chemical complexes start off much smaller and so forth. You're talking about something that we've written -- seen so much of the literature about, numbers of this size. And we've almost gotten to assume that these things have really been done, but they haven't been done. Now we talked about billion dollar plants in Saudi Arabia and we talked about even -- well I look at a billion dollar and a half plant in the U. S. They've never gotten built. So we're talking -- you just get kind of hypnotised at the fact that the pipeline cost 8 billion dollars. Yeah, but look who's behind the pipeline.

CHAIRMAN MILES:

What are these 200,000 barrel a day OPEC petrochemical facilities cost?

MR. MOORE:

They haven't been built yet.

CHAIRMAN MILES:

I know, but -- I know they haven't been built yet but --

AGO 545691

MR. MOORE:

Billion and a half, 2 billion dollars.

MR. CHATTERTON:

(Indisc.)

CHAIRMAN MILES:

Chat.

MR. CHATTERTON:

Thank you, Mr. Chairman. What's your definition of a petrochemical?

MR. MOORE:

Of a petrochemical from oil, from a hydrocarbic source?

MR. CHATTERTON:

Well if I were to build a petrochemical complex, buy a petrochemical complex and I made this a middle of the barrel fuel product slate, (indisc.) propane, a little butane, wouldn't that be a petrochemical complex?

MR. MOORE:

Well there isn't a legal definition of it.

MR. CHATTERTON:

There is no legal definition, is there?

MR. MOORE:

It's a term of art.

MR. CHATTERTON:

It's a great, broad, wide open (indisc.)

MR. MOORE:

We could probably decide in the sense of it being a term of art. But, you know, a normal person (indisc.) petrochemical complex.

UNIDENTIFIED SPEAKER:

That would make (indisc. -- laughter).

MR. CHATTERTON:

Joe, thank you, you've made a point, I hope. I don't want to admit it.

MR. MOORE:

Any other questions?

MR. PARR:

Tell me one thing and this, again, is an off the top of the head answer. I've got to tell you that this one company came in and discussed with a number of us on this committee, I guess, the possibility of building a strato-plant (ph) over the gas line in Fairbanks and they buy the gas and they put it through a process (indisc.) liquids and (indisc.). It's their responsibility to market the stuff. Is it your off-hand guess that such a thing might be economically viable?

MR. MOORE:

Yeah.

MR. PARR:

Do you have much information (Indisc.).

MR. MOORE:

I think the thing that -- I think that if you just do that by itself, the thing that you probably clearly could do, you could probably recover propane, butane, (indisc.) and sell those. Now that probably wouldn't really contribute anything significant to development in the state if that were your objective.

MR. PARR:

(Indisc.) planned use.

MR. MOORE:

That people would use?

MR. PARR:

Something like the (indisc.--interrupted)

MR. MOORE:

(Indisc.) people.

MR. PARR:

It would be a real big plant.

MR. MOORE:

Oh a hundred people probably.

MR. PARR:

So in terms of an increment of employment or development it's not a real big increment.

CHAIRMAN MILES:

No, it's a term of art, (indisc.) It's a downstream manufacturer is what you'd call it -- the guy who would buy this propylene or whatever it is to make something out of it.

MR. MOORE:

Make something else out of it.

MR. PARR:

And then he came along and located (indisc. -- interrupted)

MR. MOORE:

(Indisc.)

CHAIRMAN MILES:

(Indisc.)

MR. CHATTERTON:

Joe, what's a commercial name for aromatic, one of the aromatics?

MR. MOORE:

Benzine, you mean?

MR. CHATTERTON:

Okay. Let's say the bottoms from the fuel oil refinery would contain those, would it not?

MR. MOORE:

The bottoms from the fuel oil refinery?

MR. CHATTERTON:

Well the tops -- in other words, what you didn't -- if you had products like jet fuel, diesel, stove oil and the rest shifts out why that would have -- what shifts out would have aromatics in those, wouldn't it?

MR. MOORE:

Aromatics are into gasoline (indisc.) If you make these in a plain old refinery, that made gasoline --

AGO 545694

MR. CHATTERTON:

I'm not making gasoline.

MR. MOORE:

The aromatics of commerce appear in the gasoline business.

MR. CHATTERTON:

And if I don't take any out why they're still in there, aren't they?

MR. MOORE:

Yeah.

MR. CHATTERTON:

I've separated them from something.

MR. MOORE:

There's lots of aromatics, you know, if you try to be literal but the aromatics of commerce are primarily benzine and ,secondarily zyalene (ph) and third (indisc. -- noise) and anything else is not really an aromatic of commerce.

MR. CHATTERTON:

And where would our olefins fit into commerce?

MR. MOORE:

If you're not thinking gasoline?

MR. CHATTERTON

No.

MR. MOORE:

Well if you had atomic refinery, you don't have any olefins. Olefins are primarily produced in a refinery by a cracking process (indisc.)

MR. CHATTERTON:

Okay.

MR. MOORE:

Gas, oil.

MR. CHATTERTON:

Alright.

AGO 545695

MR. MOORE:

(Indisc.) cracking bottoms or they're produced by thoroughly cracking naptha. In the petrochemical business they're primarily produced in cracking steam, so called steam cracking or steam pyrolosis (ph) a derivative material producing ethylene and propylene. So that if you had a simple refinery, you normally wouldn't have any olefins (indisc.) If you start producing olefins in a normal refinery you do it because you're making --increasing the octane of gasoline. If you're not making gasoline and you're producing olefins, you're probably producing chemicals like ethylene and propylene.

MR. CHATTERTON:

Okay. Thank you. Thank you, Mr. Chairman.

CHAIRMAN MILES:

Anything else? Joe, thank you very much. You were very, very helpful.

AGO 545696

PETRO MARKETING SERVICES, INC.

(2) He still makes no argument for interim taking. All the reasons for not allowing interim sales remain pp 1, 5.

(3) What about other concerns! "commit to expend" p 5

Supplementary Statement By

Earl Johnson

Before The

Senate Special Committee on Royalty Oil and Gas

State of Alaska

May 15, 1978

(1) "The scope of my concern and my comments is essentially from the standpoint of effective crude oil marketing -- the area of my special expertise"...

Doesn't it seem he knows too much about marketing to revise his statements so drastically!!!

AGO 54[illegible]697

P.O. BOX 7343 • TULSA, OKLAHOMA 74105 • (918) 747-5341

Senators.

Since testifying before this committee on May 11, I have received and noted several items of additional information that I consider pertinent and highly significant -- enough so, in fact, to appreciably alter some of my attitudes toward the Alpetco contract as it pertains to royalty oil purchases. These changes also must affect my testimony and I should like to make the following brief statement prior to further consideration of the Alpetco matter.

Following my testimony on May 11, I discussed the Alpetco contract with Commissioner LeResche and Deputy Commissioner Boness, especially with regard to my testimony which opposed early taking of royalty oil. I characterized such early taking of crude by Alpetco as a probable indirect subsidy to the project by the State due to my visualizing an opportunity for Alpetco to purchase crude under the contract's pricing formula at a price which would permit them to discount North Slope royalty oil on the West Coast -- and still make a profit.

I found my discussion with Mr. LeResche and Mr. Boness very enlightening. Both of these gentlemen are exceptionally well informed both with respect to the subtleties of the Alpetco

AGO 545698

contract and with respect to the crude oil marketplace generally.

In arriving at some of the conclusions outlined in my earlier testimony, I had used a weighted average price FOB Valdez of $11.45, based on the marketing of 2/3 royalty oil on the West Coast (and Valdez) and 1/3 on the Gulf Coast. These figures are essentially correct, but do not fully address the unique pricing mechanism in the proposed contract. This pricing mechanism contains a feature that substitutes the average point of delivery price of all of the other producers for the actual price of any producer whose actual point of delivery price is lower than the weighted average price of all of the other producers. This feature tends to protect the state from receiving a low price from Alpetco under any circumstance, but especially under those actual crude marketing practices now existing with respect to North Slope crude. Specifically, some 61% of North Slope Crude was marketed at Valdez and on the West Coast during March 1978, with the other 39% going to the Gulf Coast. The calculated weighted average price at TAPS inlet was $5.16 per barrel ($11.43 FOB Valdez). However, the pricing in the contract would set the Alpetco purchase price under the contract at $6.09 at TAPS inlet ($12.36 FOB Valdez). Since this would result in a delivered West Coast cost to Alpetco of approximately $13.25, there would obviously be no incentive for Alpetco to exercise its crude option -- and certainly no way to discount in the West Coast Market

Didn't he read the contract?

(since the going rate forNS crude is approximately $13,00 per barrel at present.) This pricing anamoly results essentially from the fact that almost all of the crude going to the Gulf Coast is Sohio's. Their crude is thus priced at a weighted average $4.34 at TAPS inlet. Since the weighted average price of all other producers (excluding Sohio) is $6.09, this price is substituted in the pricing formula as the price per barrel for Sohio's crude in weight averaging all crudes. The foregoing prices are based on actual volumes and prices as reported to the State for March 1978. I have calculated additional simulated conditions for March and have concluded that even if Sohio commenced marketing an additional 100,000 barrels per day on the West Coast instead of the Gulf Coast, and Exxon and Arco each sold 50,000 more barrels per day on the Gulf Coast instead of the West Coast, the Alpetco price at TAPS inlet would still be $5.53 ($11.80 FOB Valez = $12.70 West Coast). Even this very substantial change in West Coast market balance between companies (which I do not regard as likely in the near future) would not produce a contract price low enough to permit Alpetco to discount significantly in the West Coast market and still achieve a profit on the sale of crude.

Because of this special pricing feature, the full import of which I had not realized at the time of my earlier testimony, I now believe there is very little likelihood of Alpetco's early taking of crude; and even less likelihood that if such early taking does occur (after 25 months), that the State

What about their most recent scenario?

AGO 545700

would be adversely affected as to price. In the light of my more complete information, I visualize the Alpetco's possible sales of crude on the West Coast would have no serious effect in the West Coast marketplace. I retract my earlier statement regarding the crude option to Alpetco constituting an indirect subsidy by the State to the Alpetco projects, since I have been convinced that the State is reasonably protected by the pricing clause.

The foregoing represents a substantial alteration in my testimony since last week. Briefly stated, I now feel much more comfortable about the crude dedication features of the Alpetco contract.

they should! They negotiated the contract

As earlier stated, I have been very favorably impressed with the grasp that your Royalty Commissioner and his staff have of the contract and its implications. Certainly, from the standpoint of the present administration attitude, one can feel assured that the bench mark requirements would indeed be rigidly and narrowly interpreted.

Thank you for the opportunity to amend my earlier testimony. My change of attitude about part of the contract is based on several hours of calculation based on actual March 1978 movements of crude as reported and an application of the Alpetco purchase price clause to these actual crude deliveries and modifications thereof.

AGO 545701

AMENDMENT

Dated May 17, 1978

to the

AGREEMENT FOR THE SALE AND

PURCHASE OF STATE ROYALTY OIL

THIS AMENDMENT entered into as of the 17th day of May, 1978, by and between THE STATE OF ALASKA, hereinafter called the "Seller," acting by and through its Commissioner of Natural Resources, and ALASKA PETROCHEMICAL COMPANY, an Alaska corporation, hereinafter called the "Buyer," and being the Amendment to the Agreement between Seller and Buyer entered into February 22, 1978.

WITNESSETH:

WHEREAS, an Agreement for the Sale and Purchase of State Royalty Oil was duly executed on February 22, 1978, between the State of Alaska, as Seller, and Alaska Petrochemical Company, as Buyer ("Agreement"); and

WHEREAS, the Agreement may be amended under Article XXII thereof; and

WHEREAS, Seller and Buyer desire to clarify certain intentions of the Buyer and Seller therein;

NOW THEREFORE, in consideration of the representations, covenants and conditions herein contained, Seller and Buyer hereby amend the Agreement as follows:

AGO 545702

1. Article 1.13 is hereby amended by adding the following sentence at the end of Article 1.13:

"Total Project Costs shall not include any amounts paid for the purchase of crude oil."

2. Article I is hereby further amended by the addition of Article 1.14 which reads as follows:

"1.14 The terms "committed to be expended" as used in Article 1.13 and "commit to expend" as used in Article 10.2 shall mean contractually binding agreements, contracts and purchase orders."

3. Article 2.2 is hereby amended by the addition of a sentence at the end of such Article 2.2 as follows:

"Notwithstanding any other provision of this Article 2.2 Buyer shall not be entitled to receive delivery of any royalty crude oil hereunder until (a) Buyer has actually expended at least $100 million in Total Project Costs, and (b) at least twenty-five (25) months have passed since the Effective Date."

4. Article II is further amended by the addition of a new Article 2.7, to read as follows:

"2.7 Reduction of Quantity of Oil Deliverable to Buyer. Notwithstanding any provision of Article II requiring Seller to deliver to Buyer quantities of crude oil up to 150,000 barrels per day, in the event six years after the Effective Date the

AGO 545703

capacity of the Petrochemical Facility is less than 150,000 barrels per day, the maximum quantities deliverable by Seller for the remaining term of this Agreement shall be reduced to that quantity equal to the capacity of the Petrochemical Facility at such time. Coincident with such reduction, the figure "145,000 barrels" appearing several places in Article 2.4 shall be reduced by a like amount. For the purposes of determining capacity under this Article 2.7, the capacity of the Petrochemical Facility shall not be diminished or reduced because of temporary reductions due to market conditions or shutdowns in the Petrochemical Facility, regardless of cause."

5. The first sentence of Article 4.2.1 is hereby amended and revised to read as follows:

"4.2.1 Construction Obligations. In consideration of the obligations assumed by each party herein, Buyer will proceed with reasonable diligence to design, construct, start up and thereafter initiate operation of a petrochemical manufacturing and fuels refining facility in the State of Alaska with capacity to process at least 150,000 barrels of crude oil per day."

IN WITNESS WHEREOF, the Seller has caused this Agreement to be executed by its Commissioner of Natural Resources and the Buyer has caused this Agreement to be executed by its

Chairman of the Board, thereunto duly authorized by its Board of Directors in accordance with the certified seal, duly attested, to be affixed hereto, as of the day and year first above written.

THE STATE OF ALASKA

ATTEST:

BY: Commissioner, Department of Natural Resources
"SELLER"

APPROVED AS TO FORM:

ALASKA PETROCHEMICAL COMPANY

ATTEST:

BY: Chairman of the Board
"BUYER"

AGO 545705

AGREEMENT FOR THE SALE AND PURCHASE

OF

STATE ROYALTY OIL

ALASKA PETROCHEMICAL COMPANY
an Alaska corporation

THE STATE OF ALASKA
Department of Natural Resources

February 22, 1978

AGO 545706

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AGREEMENT FOR THE SALE AND

PURCHASE OF STATE ROYALTY OIL

THIS AGREEMENT entered into as of the 22nd day of February, 1978, by and between THE STATE OF ALASKA, hereinafter called the "Seller," acting by and through its Commissioner of Natural Resources pursuant to Alaska Statute 38.05.183 and ALASKA PETROCHEMICAL COMPANY, an Alaskan corporation, hereinafter called the "Buyer."

W I T N E S S E T H :

WHEREAS, it is in the mutual best interests of Seller and Buyer that Buyer construct and operate a petrochemical facility in Alaska to process the oil sold hereunder, said facility to have the capacity to process approximately 30,000 barrels per day of crude oil into energy fuels for in-state distribution and sale; and

WHEREAS, Seller has the right under each of the leases identified in Exhibit "A" to this Agreement to be delivered or paid by the Lessee thereunder a royalty of twelve and one-half percent (12-1/2%) in kind (amount) or value of the crude oil production removed or sold from the lands covered by each such lease; and

WHEREAS, the Lessees of such aforesaid leases and other parties have represented to Seller that crude oil can be recovered from such leases in significant quantities and that such Lessees intend to market such crude oil; and

AGO 545712

WHEREAS, Seller is presently receiving royalty payments based on more than 90,000 barrels of crude oil per day from the aforesaid leases and anticipates the quantity of such royalty oil payments to increase for the next year; and

WHEREAS, Seller is authorized by Alaska Statute 38.05.183 to sell such royalty oil; and

WHEREAS, Seller desires to sell royalty oil to Buyer and Buyer desires to purchase royalty oil from Seller under the terms and upon the conditions hereinafter set forth;

NOW, THEREFORE, in consideration of the representations, covenants and conditions herein contained, Seller and Buyer hereby agree as follows:

ARTICLE I

DEFINITIONS

As used herein, the following terms shall have the following meanings:

1.1 "Affiliate" shall mean any person, firm, corporation or other entity affiliated with Buyer by means of a material direct or indirect ownership interest.

1.2 "Commissioner" means the Commissioner of Natural Resources of the State of Alaska.

1.3 "Date of First Delivery" means the date the first royalty oil sold hereunder passes the Point of Delivery.

1.4 "Day" means a period of twenty-four (24) consecutive hours beginning at 12:01 a.m., Alaska Standard Time.

AGO 545713

1.5 "Effective Date" shall have the meaning defined in Article XI.

1.6 "Force Majeure" shall have the meaning defined in Article 15.2.

1.7 "Leases" or "Lease Contracts" means the oil and gas leases which are described in Exhibit "A" attached hereto and made a part hereof.

1.8 "Lessee" means any party owning a working interest in a Lease or Lease Contract.

1.9 "Month" means the period beginning at 12:01 a.m., Alaska Standard Time, on the first day of the calendar month and ending at the same time on the first day of the next succeeding calendar month.

1.10 "Oil" or "crude oil" shall have the same meaning as the word "oil" under the Prudhoe Bay Unit Agreement dated April 1, 1977, by and between the Seller and Lessees.

1.11 "Point of Delivery" shall have the meanings defined in Article III.

1.12 "Petrochemical Facility" shall have the meaning defined in Article 4.2.1.

1.13 "Total Project Costs" shall mean the aggregate of all sums and costs expended, incurred or contractually committed to be expended by Buyer, its Affiliates, direct and indirect beneficial shareholders, consultants, advisers and design, engineering and construction contractors in connection with responding to the requests

AGO 545714

for proposal for the sale of royalty oil from the Leases; the preparation and execution of this Agreement; the performance of any and all obligations, transactions or events required by this Agreement; and the design, engineering and construction of the Petrochemical Facility or any portion thereof, all such costs to be measured from January 1, 1975. Total Project Costs shall also include (i) interest costs actually paid or accrued, and (ii) sums and costs expended, incurred or contractually committed to be expended by any city, borough or other governmental agency on any pollution control, sewage or water treatment, port, pipeline, terminal or other facilities, directly connected with or a part of the Petrochemical Facility, to the extent such facilities are utilized by the Petrochemical Facility. Any indirect or allocated costs shall be substantiated in writing to the satisfaction of the Commissioner.

ARTICLE II

QUANTITY PURCHASED AND SOLD

2.1 Sale of Prudhoe Bay Royalty Oil. Subject to the terms and conditions hereinafter provided, and subject to the prior obligations of Seller to deliver 5,000 barrels of crude oil per day under its contract with Golden Valley Electric Association, Inc. ("Golden Valley"), for the term and in the quantity now stated therein, Seller agrees to sell to Buyer, and Buyer agrees to buy from Seller, eighty-five percent (85%) of the total amount of Seller's royalty oil out of the crude oil production removed or sold from the Leases which the Seller has the right to take, and is available to the Seller for tak-

AGO 545715

ing, in kind. Seller reserves the right to use or dispose of the remaining fifteen percent (15%) in its discretion. After completion of the Petrochemical Facility, Seller's obligations to Golden Valley, if any, shall first be satisfied out of the fifteen percent (15%) portion of the oil from the Leases not being sold by Buyer hereunder. In addition to the crude oil deliverable under the other provisions of this Article 2.1, Buyer shall also possess the option to purchase an additional five percent (5%) of the total amount of Seller's royalty oil out of the Leases:

(a) in the event Seller enters into a contract with North Pole Refining Company ("NPR") granting NPR an option to purchase part or all of the fifteen percent (15%) portion of the oil out of the Leases not sold to Buyer under other provisions of this Article 2.1 and NPR does not exercise its option in full to purchase the oil on which it has an option, but Buyer's option to purchase shall extend only to the purchase of that quantity of oil from time to time not purchased by NPR; or

(b) in the event Seller does not enter into or have in effect a contract with NPR as recited in Article 2.1(a).

In the event it exercises its option under Article 2.1(a) or 2.1(b) above, Buyer agrees to give Seller an additional thirty (30) days notice of any nominations under this Article in addition to the time for notice specified in the Prudhoe Bay Unit Agreement. In the event under any agreement with NPR Seller obtains a right to purchase

5% add. out of 15% if NPR does not exercise its option to the 15%

or 5% add. out of 15% if there is no contract with NPR

AGO 545716

from NPR any oil returned to the Trans Alaska Pipeline System by NPR, Seller shall assign all such rights to Buyer for the term of such NPR agreement.

Seller represents to Buyer that it has obtained sufficient advance written consents to termination and an agreement from Lessees (which to Seller's knowledge has been performed) to require similar consents from all subsequent purchasers agreeing to waive or terminate any supplier-purchaser relationship as to sufficient quantities of Seller's royalty crude oil out of the Leases to enable Seller to perform its delivery obligations under this Agreement.

2.2 Initiation of First Delivery. After the date Buyer has obtained the financing commitment referred to in Article 10.2(3)(d) and has furnished satisfactory evidence of same to Seller, Buyer shall have the right, subject to the further terms of this Article 2.2, to call for the initiation of delivery of crude oil under this Agreement by notifying Seller that Buyer seeks to initiate deliveries and stating the quantity desired, which such quantity shall be not less than one thousand (1,000) barrels per day. Initiation of deliveries, therefore, may occur prior to the date the Petrochemical Facility is completed and operational. Seller, within thirty (30) days after receipt of such notice from Buyer, shall deliver notice to all Lessees that it is exercising its right to take its royalty oil in kind and stating the quantity required to be delivered. In the event Seller shall obtain a modification of the Lease Contracts or Prudhoe Bay Unit Agreement to reduce the notice period required to less than six (6) months, the Date of First Delivery under this Agreement shall be reduced accordingly, but only upon sixty (60) days' prior written

AGO 545717

notice of such time reduction to Buyer. Buyer agrees, in the event it calls for delivery of crude oil prior to the date the Petrochemical Facility is ready to process the crude oil, that it shall fully comply with its obligations under Article 26.6.

2.3 Certain Future Sales of Oil Taken in Kind by Seller. From and after the Effective Date, as to any royalty oil of Seller (other than royalty oil out of the Leases) taken in kind and proposed to be offered for sale, other use or disposition to third parties by Seller at a price or value which, when the reasonable costs of transportation of such royalty oil to the site of the Petrochemical Facility are added thereto, is less, on the date so offered, than the price stipulated in Article 8.1 plus the reasonable costs of transportation from the Point of Delivery to the site of the Petrochemical Facility, equitably adjusted to reflect quality and gravity differences between the crude oil offered to be sold and the crude oil from the Leases, Seller shall first offer to Buyer the opportunity to purchase ninety percent (90%) of the royalty oil proposed to be offered. Said oil shall be offered to Buyer at the same price, and on the same terms and conditions, as offered to third parties. The offer to Buyer shall remain open for sixty (60) days, after which time, if Buyer has not accepted the offer, Seller shall be free to sell the oil under the same terms and conditions to a third party. Seller may freely dispose of the ten percent (10%) portion of the royalty oil not sold to Buyer hereunder at such price and on such terms as Seller may desire. Notwithstanding the preceding provisions of this Article 2.3, Seller may freely sell any of its royalty oil otherwise subject

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to this Article 2.3 free of the terms of this Article 2.3 so long as any such sales and deliveries of oil at a lower price, as defined above cease and terminate on the date the Petrochemical Facility initiates processing of crude oil; further, the provisions of this Article 2.3 shall not apply to Seller's currently pending contract for the sale of oil out of the Leases to North Pole Refining Company and except for any renewal or renewals of the current contract of Seller with Tesoro Petroleum Company ("Tesoro") for a like quantity of oil as is now being delivered under Seller's contract with Tesoro. If Buyer purchases oil pursuant to the provisions of this Article 2.3, Buyer may reduce its purchases of royalty oil from the Leases by a like amount (and shall do so to the extent its aggregate purchases of all Seller's royalty crude oil under all provisions of this Agreement exceed 150,000 barrels per day, averaged monthly) during the period it is purchasing oil pursuant to this Article 2.3. Such reductions shall be effected in accordance with the restrictions of Article 2.5 and subject to Buyer's obligation to buy and receive such oil as it has previously nominated. Oil purchased pursuant to this Article 2.3 shall be deemed oil out of the Leases for the purposes of Article 14.1(ii) only.

2.4 Buyer Option in the Event Certain Quantities Not Delivered. Upon and after the inception of operation of the Petrochemical Facility, in the event at any time and from time to time Seller has not made available for delivery to Buyer for more than two (2) consecutive months average daily quantities (averaged monthly) of royalty crude oil from the Leases equal to or in excess of 145,000 barrels per day, upon written request by Buyer, Seller shall immediately exercise any option which it as lessor may then possess, as directed by Buyer, under any other lease or leases to receive its royalty crude oil in kind rather than in value in order that Buyer has the ability to receive from Seller 150,000 barrels of oil per day, with such prior notification to the lessees under such

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other leases as may be required thereunder; provided, however, that such option exercise by Seller shall only apply to seventy percent (70%) of the available royalty oil to be taken in kind and only as to such quantity of royalty crude oil as may be necessary to assure Buyer of the availability of 150,000 barrels per day in the aggregate. To protect and insure Buyer's right to receive at least 150,000 barrels of crude oil per day hereunder, after the date of execution hereof and for the full term hereof, all contracts for the sale of any royalty crude oil of Seller taken in kind (except for Seller's currently pending contract for the sale of oil out of the Leases to North Pole Refining Company and except for any renewal or renewals of the current contract of Seller with Tesoro for a like quantity of oil as is now being delivered under Seller's contract with Tesoro) shall contain a provision that Buyer shall possess a paramount right to call for and receive such royalty oil in the event deliveries to Seller from the Leases and available for sale and delivery to Buyer fall below 145,000 barrels per day pursuant to the provisions of this Article 2.4. Notwithstanding any other provisions contained in this Article 2.4, Buyer's option hereunder shall extend only to seventy percent (70%) of the royalty oil production of any field, lease, or contract in which Seller has an interest. Seller agrees that any lease agreements and agreements for the sale of royalty crude oil taken in kind hereinafter entered into will include the advance written notice of the purchaser, exchange partner or other recipient of the crude oil to the termination of any supplier-purchaser relationship which may be deemed to exist

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with respect to the State of Alaska royalty crude oil for purposes of any mandatory crude oil allocation program under applicable law or regulations of the Department of Energy or its successors then in effect upon the call therefor by Buyer under the provisions of this Article 2.4. In order to effectuate the purposes of this paragraph Seller shall furnish Buyer such information as Buyer reasonably requests from time to time concerning leases of which the State is Lessor and possesses the right to receive its royalty in kind. At such time as the average daily quantity of crude oil available to be delivered pursuant to the provisions of Articles 2.1 and 2.3 reaches or exceeds 150,000 barrels per day for more than two (2) consecutive months after such option has been exercised by Buyer, Seller shall have the right to terminate Seller's taking of royalty crude oil in kind under the other leases as described above in this Article 2.4, upon prior written notice which is thirty (30) days more than the period necessary to provide legal notice to Seller's lessees of Seller's return to taking its royalty in value rather than in kind, but on not less than ninety (90) days' written notice to Buyer. Thereafter, Buyer shall again be entitled to exercise its rights under this Article 2.4 should the aggregate average quantity of 145,000 barrels of crude oil per day available to be delivered under Articles 2.1 and 2.3 not be attained for more than two (2) consecutive months. If for any reason Buyer's election or elections to receive oil under this Article 2.4, along with the other obligations of Buyer to receive oil under this Agreement result in Seller being required to take from its Lessees or the lessees referred to in Articles 2.3 and 2.4

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more than 150,000 barrels per day, Buyer will take all such oil from Seller and shall advise Seller so that Seller may give notice to its Lessees to reduce the quantities of oil it is taking in kind pursuant to Buyer's nominations to an aggregate of 150,000 barrels per day.

2.5 Increases or Decreases of Crude Oil. Notwithstanding any other provision of this Agreement to the contrary, after the Date of First Delivery and from time to time thereafter, Buyer shall have the right upon notice to Seller to require Seller to exercise its right under the Prudhoe Bay Unit Agreement (and under any other lease the oil from which is being sold to Buyer under Articles 2.3 and 2.4 if the terms of such lease so permit) to increase or decrease, by the terms of said Unit Agreement (or lease), the quantity of royalty oil to be delivered to Seller, and the quantity of royalty oil to be delivered to and purchased by Buyer under this Agreement shall be so adjusted; provided, however, that the provisions of this Article 2.5 shall not operate or be construed to require that Seller deliver and sell to Buyer the percentage portions of Seller's royalty oil out of the Leases or out of the leases referred to in Articles 2.3 and 2.4 which Seller has expressly reserved as not to be sold and deliverable hereunder, and further provided that Seller shall not be required to deliver more than 150,000 barrels per day hereunder as an average daily delivery during any calendar month. In addition to the time for notice specified in the Prudhoe Bay Unit Agreement (or any such other lease), Buyer agrees to give Seller an additional thirty (30) days' notice of any nominations under this paragraph. In order to provide maximum administrative efficiency, nominations

under this Article 2.5 shall be made not more than once every thirty (30) days.

2.6 Delivery of TAPS Fill by Seller. Upon initiation of deliveries pursuant to Article 2.2, Seller in addition to all other quantities of crude oil deliverable hereunder shall deliver to Buyer on or prior to the Date of First Delivery a sufficient quantity of crude oil for Buyer to fulfill its tariff obligations to supply Trans-Alaska Pipeline System pipeline fill and storage tank bottom requirements. Buyer shall pay for such quantity of oil on the date of termination pursuant to the provisions of Article IX, X or XIV hereof, at the price stipulated in Article VIII as if such oil had been delivered to Buyer at the Point of Delivery forty-five (45) days prior to the said date of termination. In the event that Buyer, prior to the completion of the Petrochemical Facility, suspends its purchase of oil from the Leases after having initiated deliveries and after Seller has delivered the pipeline fill and storage tank bottom requirements as provided by this Article 2.6, Buyer shall pay for such quantity of oil as if it had been delivered at the Point of Delivery on the date Buyer suspended its purchases. Thereafter Seller shall again be obligated to provide pipeline fill and storage tank bottom requirements upon Buyer's reinitiation of deliveries of oil out of the Leases as provided by other provisions of this Article II.

ARTICLE III

POINT OF DELIVERY AND PASSAGE OF TITLE

3.1 Point of Delivery. Delivery of the oil sold from

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Seller to Buyer under Article 2.1 shall be made at the Seller's or Lessees' A.C.T. meter at the inlet inception point of the Trans-Alaska Pipeline System at Pump Station Number 1, Prudhoe Bay, Alaska. Delivery of any oil sold pursuant to the provisions of Articles 2.3 and 2.4 shall be at the same point of delivery that such oil is delivered to Seller by the lessee paying such oil as royalty oil in kind to Seller. Delivery under this Article 3.1 may be made at such other point or points of delivery as may be mutually agreed between Buyer and Seller. The Point or Points of Delivery set forth in this Article 3.1 shall hereinafter be referred to as the "Point of Delivery" or "Points of Delivery."

3.2 Passage of Title. Title to the oil to be sold hereunder shall pass from Seller to Buyer upon delivery.

3.3 Buyer's Responsibility. Buyer shall be responsible for the oil to be sold hereunder after passage of title hereunder. Buyer shall indemnify and hold Seller harmless from and against any and all claims, costs, damages, expenses or causes of action as a result of any loss, injury or damage incurred by any party as a result of any transaction or event which relates to the crude oil after title thereto has passed to Buyer. Buyer shall make all necessary arrangements for transporting the oil sold hereunder from the Point of Delivery to the Petrochemical Facility.

ARTICLE IV

REPRESENTATIONS AND OBLIGATIONS OF BUYER

Buyer represents, warrants and agrees that:

4.1 Good Standing. Buyer is and at all times hereunder

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will remain a corporation qualified to do business in, and in good standing with, the State of Alaska.

4.2 Construction of a Petrochemical Facility in the State of Alaska.

4.2.1 Construction Obligations. In consideration of the obligations assumed by each party herein, Buyer will proceed with reasonable diligence to design, construct, start up and thereafter initiate operation of a petrochemical manufacturing facility with fuels refining capacity in the State of Alaska. Such facility shall include facilities for the manufacture of energy fuels, aromatics, olefins and petrochemical derivatives of such basic feedstocks, and will include "offsite" facilities such as power supply, water supply, port facilities and administration buildings. Final process configuration and production rates of the various products listed above will be determined by (i) marketing considerations based on sales contracts for the products and (ii) process optimization of the overall facility design to produce the desired products in the most effective manner. Variations in process optimization will occur throughout the anticipated life of the facility. Such facilities shall be hereinafter referred to as the "Petrochemical Facility."

what does that really mean?

4.2.2 Siting of Petrochemical Facility. Buyer has chosen several preferred sites for the location of its Petrochemical Facility. Buyer shall notify the Commissioner no later than six (6) months after the Effective Date which site it has chosen (and the reasons for its choice of such site in reasonable detail), which such

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site shall be subject to the approval of the Commissioner within ninety (90) days after receipt of notice by Seller of Buyer's choice of site. In making his decision, the Commissioner shall consider, among other things, the desires of the people who live in the immediate surroundings of any proposed site. Failure of Buyer to receive written reply from the Commissioner within such ninety (90) day period shall be deemed an approval of the site selection; provided, however, that such approval shall in no manner diminish or alter Buyer's obligation to obtain all requisite state and federal permits, licenses and applications or to comply with other applicable laws or regulations. In the event the Commissioner disapproves a proposed site, Buyer shall resubmit with additional pertinent information its original proposed site or shall propose an alternate site to the Commissioner within ninety (90) days from the date Buyer receives notice of disapproval. Resubmissions or submissions of alternate sites shall continue in like manner until a site is approved by the Commissioner. Or until ALPETCO cancels contract after two site submissions under 10.3.

4.2.3 Progress Reports by Buyer. From the Effective Date and until the conditions stated in Articles 10.2(1) through 10.2(3) have been satisfied, on or before the twentieth (20th) day of each month, the Buyer shall furnish the Commissioner a written progress report as of the end of the preceding calendar month describing compliance with the requirements of such Articles, the engineering, design and construction activities of Buyer with respect to the Petrochemical Facility, progress in the marketing of the products therefrom, and the proposed financings and scheduled expenditures of the Buyer. After fulfillment of all the conditions stated

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in Articles 10.2(1) through 10.2(3) and until all the conditions stated in Articles 10.2(4) through 10.2(9) have been satisfied, Buyer shall furnish like progress reports (also to be on the twentieth (20th) day of the month) each calendar quarter as of the end of the calendar month immediately preceding the month in which the report is made, beginning on the twentieth (20th) day of the third month next following the month during which the conditions under Articles 10.2(1) through 10.2(3) were fulfilled. Such reports, or portions thereof, shall be held confidential as requested by Buyer to the extent permitted by law.

4.3 Production of Energy Fuels for Intrastate Use. In order to provide fuels for distribution within the State of Alaska, Buyer shall design and construct the Petrochemical Facility to include a capacity to process 30,000 barrels of crude oil per day into energy fuels. If Buyer does not utilize the royalty oil sold and delivered hereunder, or traded or exchanged oil, in the Petrochemical Facility, then it shall utilize its best efforts to assure that at least 30,000 barrels per day of said royalty oil will be processed instate for production into energy fuels for intrastate distribution and sale, unless such processing would be surplus to the then prevailing intrastate domestic and industrial needs.

4.4 Establishment of Charitable Foundation. Buyer covenants and agrees to establish the Alaska Endowment Trust, the purpose of such trust being to further the social, educational, cultural and environmental conditions in the State of Alaska. The

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Alaska Endowment Trust shall be established under the terms of a trust instrument proposed by Buyer and approved by the Governor of Alaska and Alaska Legislature; the trust corpus shall be administered by a Board of Trustees unaffiliated with Buyer. Trustees shall be appointed by the Governor of Alaska and confirmed by the Alaska Legislature. The corpus of the Alaska Endowment Trust shall be created from contributions by Buyer of amounts equal to five percent (5%) of the net after-tax profits, as hereinafter defined, realized from the operation of the Petrochemical Facility and sale of fuels and petrochemical products produced from the Petrochemical Facility. Each such annual contribution shall be paid on or before July 1 of each year based upon the net after-tax profits of the immediately preceding calendar year, the first such year of measurement to commence on January 1 next following ten (10) years after the Petrochemical Facility is completed, as measured by the delivery of the certificate of completion and operability by the prime contractor of Buyer in charge of construction of the Petrochemical Facility or sixteen (16) years after the Effective Date, whichever is earlier. "Net after-tax profits" shall mean the net income of Buyer prior to deduction or accrual of amounts payable under this Article 4.4 and shall be determined in accordance with generally accepted accounting principles applied on a consistent basis after deduction for all taxes which would have been provided for in the financial statements of Buyer for the year but for the payment of the amounts payable under this Article 4.4. Since the parties

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have assumed that payments under this Article 4.4 will be deductible as an expense for purposes of any tax imposed on the income of Buyer, in the event any taxing authority does not permit such deduction, the amount payable hereunder shall be adjusted to reflect such non-deductibility. Charges made by or to any Affiliate shall be reasonable and shall not exceed those charges which would have been made in arm's length bargaining with an unaffiliated party in light of all the circumstances of the transaction, including the length of term of any contracts, financing terms and any other direct and indirect benefits offered or received. All sales between Buyer and any Affiliate shall be at a fair market price or value for such goods or services in light of all the circumstances, including the length of term of any contractual relationship, financing terms and any other direct or indirect benefits offered or received.

ARTICLE V

REPRESENTATIONS AND OBLIGATIONS OF SELLER

Seller represents, warrants and agrees that:

5.1 Seller's Royalty Oil. Pursuant to the Leases and the leases presently in effect and referred to in Article 2.4, Seller has the right to take its royalty in kind (amount), which royalty oil it represents is at least twelve and one-half percent (12-1/2%) of any crude oil production removed or sold from the Leases, unless otherwise described in Exhibit "A".

5.2 Title. Seller hereby warrants good and marketable title to the oil sold by it hereunder and its right to sell the same,

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and warrants that all such oil is owned by Seller free from all liens, encumbrances and adverse claims.

5.3 Storage of Oil. Under Paragraph 13 of the Lease Contracts, Seller may be entitled, under certain conditions, to storage of Seller's royalty oil from Lessees free of charge. Seller hereby licenses to Buyer its storage rights, if any, under the Leases (and under any other leases the oil from which is being sold to Buyer pursuant to Articles 2.3 and 2.4) effective upon the Date of First Delivery, to the fullest degree permissible under the Lease Contracts and to an extent proportionate to the proportion of Seller's royalty oil being delivered hereunder. Seller further agrees that it will aid and work with Buyer to resolve any uncertainties or ambiguities concerning Seller's right to storage under the Lease Contracts, including the institution and pursuit of litigation at Buyer's cost to clarify Seller's legal rights of storage under said Paragraph 13. Buyer and Seller agree that their mutual objective shall be to maximize the Seller's and Buyer's rights to receive storage of the oil from the Lessees. Notwithstanding anything stated herein, Seller does not warrant that it possesses any right or rights to storage under the Lease contracts or any other leases. Buyer agrees that any failure to obtain storage hereunder from the Lessees shall not relieve Buyer of its obligations under Article 10.2. Buyer will indemnify Seller and hold it harmless against all claims, costs, loss or liabilities arising from Buyer's use of said storage facilities or rights.

5.4 Covenant to Aid in Obtaining Governmental Permits. In order to construct the Petrochemical Facility, Buyer must obtain numerous permits, licenses and authorizations from state, federal and other governmental authorities. Seller agrees to utilize its best efforts to support, lend aid and facilitate the grant or approval of Buyer's applications for such permits, licenses and authorizations; provided, however, that the obligations stated herein shall not require Seller to support, lend aid or facilitate the grant or approval of any permits, licenses and authorizations which do not comply with applicable rules, regulations or laws, and provided further that Seller's obligations herein shall not require Seller to waive, rescind, modify or otherwise alter (either in substance or procedure) any of Seller's regulatory responsibilities. Seller, acting through the Commissioner, within thirty (30) days after the Effective Date shall appoint a state official who shall act as Seller's coordinator for the purpose of facilitating the granting of permits by Seller and to act as a liaison officer for Buyer and Seller with the federal government. Such designation may be changed from time to time by the Commissioner.

5.5 Delivery of Information to Buyer. Seller shall deliver to Buyer without cost to Seller (unless any costs to Seller be indemnified by Buyer) within thirty (30) days after the Effective Date:

> (i) the most recent report it possesses or can obtain from third parties concerning the volume of hydrocarbons originally in place and the portions or fractions thereof which will be recovered from the Prudhoe Bay unit reserves, accompanied by any related studies or data pertaining to such report;

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(ii) the most recent anticipated production schedules of oil, solution gas, gas cap gas and condensate in its possession or obtainable from third parties out of the Prudhoe Bay unit by year; and

(iii) the most recent information, projections or estimates in its possession or obtainable from third parties of anticipated crude oil discovery and production in Alaska during the term of this Agreement.

During the term of this Agreement, as reasonably requested by Buyer in writing, Seller shall furnish updated information pertaining to Subparagraphs (i) through (iii) of this Article 5.5. Certain information and documents, including but not limited to well logs and related production data pertaining to the Leases and other leases referred to in Articles 2.3 and 2.4 may be required by law or regulation to be held confidential by Seller, its representatives and agents, and such documents shall not be required to be delivered hereunder. Seller understands and acknowledges the importance of reports taken from such data in securing financing for the Petrochemical Facility, and Seller agrees to use its best efforts to obtain and furnish to Buyer all such relevant data and reports as requested by Buyer. Seller agrees to retain, at Buyer's cost, independent consultants acceptable to Buyer to review confidential data, to prepare such updated reports and to state such opinions as may be reasonably requested by and furnished to Buyer to the extent permitted by applicable law and regulation. Seller's obligations under this section are for the purpose of aiding Buyer in obtaining up-to-date information, some or all of which may have been furnished to Seller by third parties; accordingly, Seller does not, by provid-

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ing Buyer with the information specified in Subparagraphs (i) through (iii), warrant or represent the accuracy of such information, nor does Seller obligate itself to attempt in any way to bring about the conditions or projections contained in the information provided.

ARTICLE VI

QUALITY

6.1 Standard. The oil to be delivered by Seller to Buyer at the Point of Delivery hereunder shall be the same quality as the oil delivered by the working interest owners from the Leases and the leases. Except for the foregoing, Seller does not warrant, represent or guarantee, either expressly or impliedly the quality, merchantability, fitness for use, or suitability for any particular use or purposes, or otherwise of any oil to be delivered to Buyer under this Agreement. There are no warranties, representations or agreements concerning the quality of the oil which extend beyond the description of the oil in this Article VI.

ARTICLE VII

MEASUREMENTS AND TESTS

7.1 Testing Standards and Procedures. The quantity and quality of the crude oil sold and purchased from the Leases shall be determined at Lessees' A.C.T. meters at Pump Station One, Prudhoe Bay, Alaska. The quantity and quality of the crude oil sold and purchased from the other leases shall be determined at the Lessee's point of delivery. All measurements hereunder shall represent one hundred percent (100%) volume, consisting of United States barrels of forty-two (42) gallons, the quantity and gravity of which shall be adjusted to a temperature of sixty degrees (60°) Fahrenheit. Full deduction

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shall be made for all basic sediment and water content according to the ASTM Standard Method then in effect. Unless agreed otherwise between Buyer and Seller or set forth herein, procedures for measuring and testing and for metering the crude oil shall be completed in accordance with standard oil field practices. Procedures for metered deliveries under the Leases shall be in accordance with accepted oil field practices in effect at Prudhoe Bay, Alaska. At the direction of Buyer, Seller shall direct the Lessess or lessees to test the accuracy of their measuring equipment if and to the extent that the provisions of the Prudhoe Bay Unit Agreement or any other agreement between Seller and Lessees or lessees permit Seller to make such request. Notice of the time and nature of each test of Lessees' or lessees' measuring equipment shall be given by Seller to Buyer sufficiently in advance to permit convenient arrangement for Buyer's representative to be present. Tests and adjustments shall be made in the presence of representatives of Buyer if present at the time scheduled for such test and adjustment. At Buyer's election and subject to obtaining the permission of any necessary third parties, Buyer may also install equipment to measure or gauge all oil received by Buyer hereunder at the Point of Delivery, and Buyer shall bear the entire acquisition, calibration, maintenance and operating cost of any such loading, measuring or testing equipment required by Buyer.

7.2 Delivery of Crude Oil Samples by Seller. Upon reasonable request by Buyer, Seller at its cost shall utilize its best efforts to aid Buyer in obtaining a representative sample of one barrel of crude oil taken at Valdez, Alaska, in order for Buyer

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to perform an assay to analyze the composition, gravity, sulphur content and other characteristics of such crude oil sample. If any sample of the oil is delivered to Buyer, there is no representation or warranty by Seller that any other oil delivered hereunder will conform to the sample, it being understood that Seller will deliver only such oil as shall be delivered to it by the Lessees or lessees under the Leases or leases. Seller shall provide Buyer copies of all other assays obtained or received by it during the term thereof.

ARTICLE VIII

PRICE

8.1 Price.

8.1.1 Price of Oil Delivered Out of the Leases. As to oil sold and delivered hereunder out of the Leases, the price to be paid by Buyer to Seller shall be equal to the sum the Seller would have received from the Lessees had Seller received its royalty in value instead of taking the quantity of royalty oil delivered hereunder as its royalty in kind (amount). Seller and Buyer recognize that the method and basis of computing the royalty due Seller from Lessees under the Leases is currently a matter of dispute and litigation among the Seller and its Lessees, said litigation being entitled State of Alaska, et. al. vs. Amerada Hess Corp. et al., (No. CA 77-847, Superior Court of the State of Alaska, First Judicial District at Juneau). Pending resolution of said dispute among Seller and Lessees, by judicial decision or settlement in the above-

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referenced case, the in value royalty under the Leases, and therefore the price hereunder, shall be computed in accordance with Exhibit "B", attached hereto and by reference made a part hereof. After such time as said dispute shall be resolved among Seller and its Lessees, the parties hereto will be bound by the terms of such resolution, judicial or otherwise. Seller and Buyer expressly recognize that adjustment in prices previously paid may be necessary following said resolution and said adjustment shall be duly made, with interest, pursuant to the applicable provisions of Article IX. Any settlement agreement which agrees to the imposition of costs which are reimbursable by Buyer to Seller under Article 8.2, however, shall not be final and binding upon Buyer, unless Buyer has consented in advance to such settlement.

8.1.2 Price of Oil Sold Under Article 2.3. Oil sold pursuant to the provisions of Article 2.3 shall be the same lower price on the same terms and conditions as Seller is proposing to offer such oil.

8.1.3 Price of Oil Sold Under Article 2.4. The price of the oil sold pursuant to the provisions of Article 2.4 shall be the greater of (i) the best and highest price offered by a bona fide offeror for a like quality and quantity of the crude oil to be produced from such lease out of which oil is being delivered; or (ii) a price equal to the sum Seller would have received from its lessee or lessees had Seller received its royalty in value instead of taking the quantity of royalty oil delivered hereunder as its royalty in kind (amount).

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8.2 Reimbursement of Certain Costs of Seller. In addition to the price stated in Article 8.1, Buyer shall also reimburse Seller for Seller's pro rata share of (i) any basic sediment and water removal costs if Seller is required to pay such costs as a result of Seller's election to take its royalty oil in kind; and (ii) any other direct costs reasonably incurred and paid by Seller which would not have been incurred by Seller had the Seller taken its royalty in value rather than in kind and if such costs under Article 8.2(i) and (ii) were not previously reflected in applicable computations of value for payments of royalty in value. Seller shall use its best efforts to minimize any such costs incurred by Seller by reason of Seller's taking royalty oil in kind; such best efforts shall include but not be limited to litigation in cooperation with Buyer, at Buyer's cost, to the extent necessary to contest the imposition of unwarranted or improper charges; provided, however, that Seller shall in no event be required to advocate legal positions or adopt legal strategies which it, in its discretion, deems contrary to its own interests, in any such litigation. Seller at this date does not know of any potential costs to be incurred by it as a result of its taking in kind rather than in value other than the costs stipulated in Article 8.2(i) above.

8.3 Minimum Taking in Value by Seller. In order to facilitate the establishment of prices under Article 8.1 Seller agrees at all times during the term of this Agreement to take and receive in value rather than in kind the minimum number of barrels per day required to obtain a report of the in-value price from each Lessee.

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8.4 Federal Price Regulation. In the event a maximum price is established by the federal government during the term of this Agreement which applies to the royalty oil and which is lower than the prices established under this Article VIII above, then Buyer shall pay the Seller that maximum price for royalty oil delivered to Buyer, but only during such period such maximum price is in effect.

ARTICLE IX

PAYMENTS AND ACCOUNTING

9.1 Billing. Seller shall furnish Buyer monthly, on or before the tenth (10th) business day of each month after the first full month of delivery of crude oil, a statement of account of all crude oil delivered through and measured at the Point of Delivery during the immediately preceding month according to the best information available to Seller, the price or prices applicable thereto according to the best information available to Seller, the basis for computation of the applicable price or prices in full detail and the total net amount due. Seller shall render its billings to Buyer based upon the values, receipts, costs and computations reported by the Lessees to Seller. Seller shall thereafter adjust its initial billings pursuant to Article 9.5. Buyer and its authorized agents shall be permitted access during reasonable business hours to Seller's books and records pertinent to this Agreement to determine the correctness of the billings of Seller to the extent not contrary to law.

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9.2 Payment. Buyer shall make payment on or before the twenty-fifth day of the calendar month in which such statement is rendered or fifteen (15) days after rendition of the invoice called for in Article 9.1, whichever is later, by direct wire transfer of federal reserve funds through the Federal Reserve Bank wire transfer system to the following address or such other address as Seller may designate upon seven (7) days' prior written notice:

Bank of America, NT & SA
San Francisco, California
Securities Department 3255
Credit to: State of Alaska
Investment Account

All other payments to be made under this Agreement shall be paid in the same manner. If payment is to be made on a Saturday, Sunday or legal holiday under the preceding provisions hereof, payment shall be made on the next following business day.

9.3 Billing Disputes. Should any portion of the account furnished to Buyer by Seller be disputed in good faith, Buyer and Seller agree to mutually arrive at a fair and equitable resolution of such dispute, if possible, and Buyer agrees to pay the amount so determined to be due to Seller within fifteen (15) days after such resolution. Buyer shall pay for such amounts as it does not in good faith dispute in accordance with the provisions of this Article IX.

9.4 Late Payment Charge. If Buyer fails to make timely payment to Seller of any amount due under this Agreement, including

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any payment delayed by a bona fide dispute which is later determined to be validly owing, or if Buyer is required to pay and does pay any amount which is later determined not to be validly payable to Seller, interest shall accrue and be payable on said sum from the date when such payment was due or was paid, as the case may be, until the same is paid or repaid, at the lower of (i) a rate per annum equal to the prime rate then being charged by Chemical Bank of New York, New York, plus one and one-quarter percent (1-1/4%) per annum, or (ii) the maximum lawful rate of interest per annum which may be charged to Buyer under the laws of the State of Alaska.

9.5 Adjustments to Billings. Each month Seller shall adjust its statement of accounts to reflect the actual amounts delivered and the price or prices applicable thereto. Seller shall from time to time adjust its prior billings to reflect adjustments necessitated as a result of (i) a final judgment or settlement entered in certain pending litigation between Seller and the Lessees styled State of Alaska, et al. vs. Amerada Hess Corporation, et al., No. CA 77-847, in the Superior Court of the State of Alaska, First Judicial District at Juneau; (ii) adjustments necessitated as a result of the filing with the Seller by the Lessees of more current reports applicable to the billing period in question; (iii) actual adjustments necessitated as a result of changes to values, receipts, costs and computations previously reported by the Lessees and utilized by Seller as a basis for billing under Article 9.1, if such adjustments are based upon actual later severance tax or royalty

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oil payments by or refunds to the Lessees; or (iv) adjustments required as a result of clerical or arithmetical errors in the billings of Lessees or of Seller; provided, however, that no adjustments, whether credits or debits, under Articles 9.5(ii) through 9.5(iv) shall be made by Seller or demanded by Buyer more than twelve (12) months after billing except as to matters which are the subject of (x) pending litigation by either party, (y) pending regulatory proceedings (or appeals thereof) whether or not Seller or Buyer is a party thereto, or (z) bona fide audits by Seller which audits have been terminated or completed by Seller within twelve (12) months after initiation of same.

Due to the potentially large sums of money involved, any adjustments to any billing under the provisions of this Article 9.5 by Seller made more than sixty (60) days after such billing was initially rendered shall be paid to or refunded by Buyer or Seller over the same period over which such adjustments accrued or thirty-six (36) months, whichever is longer, beginning with the first payment next following the date such adjustment has been determined; provided, however, no such payment extension permitted hereunder shall extend beyond the term stipulated in Article 10.1, and accordingly the full balance of any unpaid adjustments shall become due and payable on the termination date hereof.

9.6 <u>Cancellation in Event of Non-Payment</u>. Except for amounts disputed in good faith, should Buyer fail to make any payment due to Seller under this Agreement (i) within sixty (60) days

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from the date said payment is due or (ii) within thirty (30) days from the date that Seller gives written notice of non-payment to Buyer in the manner provided in Article 16.1 hereinbelow (except that said notice shall be directed to the attention of the President of Buyer), whichever occurs earlier, this Agreement shall automatically be cancelled.

ARTICLE X

TERM

10.1 Term. Subject to the further provisions of Articles 10.2 and 10.3 this Agreement shall become effective on the Effective Date and except as extended by Article XV hereof shall continue and remain in force and effect for a period of twenty-seven (27) years from the Effective Date.

10.2 Termination by Seller. This Agreement shall terminate upon failure of Buyer to take each and every one of the following actions within the time specified for each, including any time extensions provided for in this Article 10.2:

(1) Within six (6) months after the Effective Date:

(a) Actually expend at least Two Million Dollars ($2,000,000.00) in Total Project Costs.

(b) Negotiate with interim lenders and obtain commitment to provide funds deemed necessary by Buyer for organizational costs and initial design costs of the Petrochemical Facility.

(c) Commence planning for optimization of design of the Petrochemical Facility.

(d) Notify Seller of Buyer's final selection of site location, such notification to be accompanied or preceded by site studies and recommendations based on preliminary engineering, including compression tests and cost estimates of infrastructure, offsite and marine facilities.

The Commissioner may extend the above six (6) month period as to Articles 10.2(1)(b), (c) and (d) thirty (30) days, but only in the event Buyer has, prior to such extension, fulfilled the requirements of Article 10.2(1)(a).

(2) <u>Within twelve (12) months after the Effective Date:</u>

(a) Actually expend at least Three Million Dollars ($3,000,000.00) in Total Project Costs.

(3) <u>Within eighteen (18) months after the Effective Date:</u>

(a) Expend or commit to expend or cause contractually bound third parties to expend or commit to expend at least Ten Million Dollars ($10,000,000.00) in Total Project Costs.

(b) Negotiate sale terms with prospective purchasers of products from the Petrochemical Facility; delineate product requirements, production ratios and quantities for the range of products to be produced from the Petrochemical Facility; and draft contracts for the sale of products from the Petrochemical Facility.

(c) Enter into contracts for the sale of at least seventy percent (70%) of the product output from the Petrochemical Facility.

(d) Obtain or cause contractually bound third parties to obtain written commitments to lend or invest at least One Billion Five Hundred Million ($1,500,000,000.00) in the aggregate for payment of Total Project Costs.

(e) Obtain a commitment or commitments for interim financing for the construction of the Petrochemical Facility.

(f) Complete and file an Environmental Impact Assessment on the Petrochemical Facility.

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(g) Complete and file all material state, local and federal permit applications.

(h) Complete plant design and optimization necessary to obtain a definitive project cost estimate ("definitive" meaning a cost estimate containing no more than fifteen percent (15%) variance in anticipated costs).

The Commissioner may extend the above eighteen (18) month period as to any one or more of the criteria or events stated in Articles 10.2(3)(a) through (h) six (6) months.

(4) Within twenty-four (24) months after the Effective Date:

(a) Expend or commit to expend or cause contractually bound third parties to expend or commit to expend at least One Hundred Million Dollars ($100,000,000.00) in Total Project Costs.

The Commissioner may extend the above twenty-four (24) month period as to the attainment of the criteria stated in Article 10.2(4)(a) six (6) months.

(5) Within thirty (30) months after the Effective Date:

(a) Execute definitive documents relating to the long-term loan of funds for the Petrochemical Facility.

(b) Commence construction of the Petrochemical Facility.

The Commissioner may extend the above thirty (30) month period as to one or more of the events or criteria stated in Articles 10.2(5)(a) and (b) above six (6) months.

(6) Within thirty-six (36) months after the Effective Date:

(a) Expend or commit to expend or cause contractually bound third parties to expend or commit to expend at least Six Hundred Million Dollars ($600,000,000.00) in Total Project Costs.

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The Commissioner may extend the above thirty-six (36) month period as to the attainment of the criteria stated in Article 10.2(6)(a) six (6) months.

(7) <u>Within forty-eight (48) months after the Effective Date</u>:

Amendment No. 2

(a) Expend or commit to expend or cause contractually bound third parties to expend or commit to expend at least One Billion Dollars ($1,000,000,000.00) in Total Project Costs.

The Commissioner may extend the above forty-eight (48) month period as to the attainment of the criteria stated in Article 10.2(7)(a) six (6) months.

(8) <u>Within sixty (60) months after the Effective Date</u>:

(a) Expend or commit to expend or cause contractually bound third parties to expend or commit to expend at least One Billion Two Hundred Million Dollars ($1,200,000,000.00) in Total Project Costs.

The Commissioner may extend the above sixty (60) month period as to the attainment of the criteria stated in Article 10.2(8)(a) nine (9) months.

(9) <u>Within seventy-two (72) months after the Effective Date</u>:

(a) Expend or commit to expend or cause contractually bound third parties to expend or commit to expend at least One Billion Five Hundred Million Dollars ($1,500,000,000.00) in Total Project Costs.

The Commissioner may extend the above seventy-two (72) month period as to the attainment of the criteria stated in Article 10.2(9)(a) twelve (12) months.

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(10) In addition to the periods of time which the Commissioner may extend the periods for performance of the criteria stated in this Article 10.2, the Commissioner may further extend the time for performance of any of the criteria stated in Article 10.2(1) through 10.2(9) for that period of time necessary to permit the Commissioner and the Alaska State Legislature to consider an amendment or modification of this Agreement, particularly of the provisions contained in Article 10.2. Such time extension shall not, however, extend beyond a period of time in excess of ninety (90) consecutive days during which the Alaska State Legislature is in session, nor shall such time extension include a consecutive period of less than ninety (90) days during which the Alaska State Legislature is in session without the prior written consent of Buyer.

10.3 Termination by Buyer. In the event that Buyer after expending all reasonable efforts fails to obtain the necessary binding commitments from interim and permanent lenders for all the funds necessary to permit construction of the Petrochemical Facility under a loan or loans providing for repayment of such loans during the life of this Agreement or fails to obtain site approval from the Commissioner after submitting at least two sites to the Commissioner pursuant to Article 4.2.2, Buyer may thereupon elect to cease design and construction of the Petrochemical Facility and terminate this Agreement without liability to either party by giving Seller notice of termination; on the thirtieth (30th) day after the giving of such notice this Agreement shall terminate, and Buyer shall deliver to Seller all documents and data pertinent to the Petrochemical Facility (or

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copies thereof) in its possession, including engineering and site selection information as may be reasonably requested by Seller.

ARTICLE XI

APPROVAL OF CONTRACT BY STATE OF ALASKA AND EFFECTIVE DATE

This Agreement shall take effect on the date on which this Agreement has been approved by concurrent resolution of a majority of each house of the Tenth Alaska State Legislature ("Effective Date").

ARTICLE XII

SECURITY

12.1 Creation of Security Interest. To secure payment of all amounts due Seller for oil sold hereunder, Seller retains and Buyer hereby grants a purchase money security interest in all of the oil delivered and to be delivered to Buyer hereunder and in all oil obtained by Buyer in exchange for oil purchased hereunder; the products made or processed from any such oil, including all substances, if any, commingled therewith, or added thereto; and in the proceeds of the sale of any such oil or products, including the accounts receivable of Buyer arising from its sales of oil or products manufactured therefrom. The security interest shall attach to the oil at the time and Point of Delivery but shall terminate as to oil or products therefrom sold to a bona fide purchaser of Buyer in the ordinary course of Buyer's business but the said security interest shall attach to the accounts receivable arising therefrom. Notwithstanding the provisions of this Article 12.1, Seller agrees that (i) the security interest in the oil shall not attach at the time and Point of Delivery but instead at the time the oil arrives and is delivered to Buyer at the outlet flange measuring device of the Valdez, Alaska terminal facility of the Trans-Alaska Pipeline System ("TAPS") as to any oil shipped under any tariff pertaining to the TAPS which contains a prohibition against carriage of oil on which a lien of a party other than the carrier thereof exists or which grants to any carrier the right to reject carriage of oil on which such a lien

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exists if Buyer has provided Seller a bond, letter of credit, marketable securities or other security, as described in Article 12.2 in an amount or of a value equivalent to the value of oil of Buyer in the TAPS on which no lien of Seller exists, unless Seller or Buyer has obtained and furnished for Buyer evidence that such prohibition or right of rejection has been effectively terminated or waived and is unenforceable; and (ii) no lien shall attach to any oil or products produced therefrom or accounts receivable created from the resale thereof as to which payments to Seller have been made for the account of Buyer if (a) such payments are not derived from the sale of property otherwise subject to the security interest of the Seller and (b) such payments are secured or are to be secured by such oil, the products produced therefrom or the accounts receivable created from the resale thereof. Seller agrees that any document filed to perfect Seller's purchase money security interest described in this Article 12.1 shall contain an exclusion to the effect set forth in the next preceding sentence. Buyer agrees that it shall not agree, or consent to, or permit the filing of, any lien or security interest in the oil other than the lien of a TAPS carrier nor shall it transfer title thereto prior to its arrival and delivery to Buyer at the outlet flange measuring device of the Valdez, Alaska terminal facility of the TAPS or prior to the attachment of Seller's security interest thereto upon such delivery. Buyer further agrees that it will not grant or consent to any security interest in the oil or other security in favor of any third party unless such third party agrees in writing prior thereto that such security interest is subordinate to the security interest of the Seller, except as provided otherwise in Article 12.1(ii). Buyer agrees to execute and file all documents necessary to perfect Seller's said security interest in the oil, proceeds from the oil and accounts receivable referred to above. "Proceeds of the sale" shall include proceeds derived from insurance or other payments resulting

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from damage to or destruction of the oil or other property covered by the security interest. To secure such payment Buyer shall cause all policies of insurance on the oil or other property to which the security interest attaches to name the Seller as coinsured as its interests may appear.

12.2 Alternative Security. In lieu of the security interest provided in Article 12.1, Buyer may provide alternative security in the form of a bond attached hereto and made a part hereof as Exhibit "C", executed by the Buyer, as principal, and a corporate surety agreed to by the Commissioner and authorized to write such bonds in the State of Alaska, as surety for a sum which shall substantially reflect the amounts owed by Buyer to Seller plus an amount equal to the value of any oil delivered by Seller to Buyer and not yet billed pursuant to Article IX; provided that whenever Seller has reasonable grounds for asserting and does assert any claims against Buyer in excess of the penal sum of the bond of Buyer then in effect hereunder, Buyer after being so requested by Seller shall either increase the penal sum of such bond to an amount reasonably sufficient to cover the claim of Seller and all expenses which may be incurred by it in connection therewith or shall furnish other security satisfactory to Seller, such as a renewed security interest in the oil or a portion thereof sold hereunder, regardless of whether the Buyer does or does not recognize the validity of the Seller's claim (so long as reasonable grounds for asserting such claim exist); provided further that the Buyer may at any time and from time to time deposit and maintain with the Commissioner at Buyer's expense in lieu of any such bond, either (i) an irrevocable letter or letters of credit addressed to the Commissioner issued by a state or national banking institution of the United States which is a member of the Federal Deposit Insurance

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Corporation and has an aggregate capital and surplus of not less than $50,000,000, or (ii) marketable securities which are approved by the Commissioner, and which shall be transferable by the Commissioner or by delivery by stock power attached or other means, such letter or letters of credit to be in an aggregate amount, or such marketable securities to be of an aggregate then fair market value, of not less than the amount then required for Buyer's bond hereunder any such letter or letters of credit and marketable securities, together with any proceeds thereof, to be held by the Commissioner for the security and benefit of the Seller; and either of (i) or (ii) to be in form and substance approved by the Seller. The amount of said letter or letters of credit or marketable securities shall be subject to increase in the same manner that the face amount of the bond is subject to increase. If marketable securities are so furnished, other marketable securities which meet the requirements of this Subparagraph (a) may be substituted at any time and from time to time for any previously furnished marketable securities, and the marketable securities so furnished shall be increased if at any time the fair market value of the securities then held by the Commissioner is less than, or may be reduced if the fair market value thereof exceeds, the amount of the bond then required of Buyer hereunder, or (iii) security which in the opinion of the Commissioner is of equal value to the security above described.

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ARTICLE XIII

TRADE OR EXCHANGE OF CRUDE

13.1 Subject to the provisions of Article 4.3 hereof and the further provisions of this Article 13.1, Buyer may trade or exchange any or all of the royalty crude oil for other crude oil or products. No trade or exchange by Buyer shall reduce the price to be paid to Seller under Article VIII hereof, and any such trade or exchange shall be without cost or expense to Seller. Buyer agrees not to trade or exchange royalty oil with another party unless that party agrees to give Buyer written permission to terminate the trade or exchange relationship upon the termination of this Agreement. Buyer shall require of any trade or exchange partner specific acknowledgment of Buyer's obligations under Article 26.6 and written permission from Buyer's trade or exchange partner to terminate the trade exchange arrangement upon termination of this Agreement. Buyer shall also require of its trade or exchange partner that it agrees to include provisions similar to this section in contracts for the sale, trade or exchange of the royalty oil and that all subsequent purchasers and trade or exchange partners will do likewise.

ARTICLE XIV

DEFAULT

14.1 Default. If

(i) either party shall fail to perform any of the covenants or obligations imposed upon it by this Agreement, except when such failure shall be excused under the force majeure provisions of Article XV, or

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(ii) for any period of six (6) consecutive months, beginning one (1) year after the Petrochemical Facility has initiated processing of crude oil into petrochemicals, and subject to the provisions of Article XV, Buyer fails to purchase in the aggregate at least one-third (1/3) of the crude oil which could be purchased by Buyer out of the Leases and the leases referred to in Article 2.4 during any calendar month, or

(iii) Buyer becomes insolvent or commits any act constituting an act of bankruptcy, or

(iv) Buyer voluntarily files an action under the United States Bankruptcy Act, or

(v) Buyer fails to obtain the dismissal of any involuntary bankruptcy proceeding filed against it under the provisions of the United States Bankruptcy Act within thirty (30) days of the filing thereof,

then and in any such event, the other party may, at its option and without waiving any other remedy for breach hereof, indicate such party's election to cancel this Agreement by notice in writing specifying in detail wherein the default has occurred. Except for the instances stipulated in Articles 14.1(iii) through (v) above, and except for payment by Buyer to Seller, which shall be governed by Article 9.6, the party in default shall have thirty (30) days from the receipt of such notice to remedy such default and to pay the other party for all loss or damage incurred as a result of such default and indemnify such party against future claims or loss arising out of such default. Upon failure of the defaulting party to remedy its breach within the time stipulated above, this Agreement may be cancelled by the non-defaulting party by service of written notice thereof upon the defaulting party. Any cancellation under Article 9.4 or this Article 14.1 [except Article 14.1(ii)] shall not

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prejudice the right of the party not in default to collect any amounts due it hereunder for any damage or loss suffered by it and shall not waive any other remedy to which the party not in default may be entitled for breach of this Agreement.

14.2 Disposition of Oil Upon Default, Cancellation or Termination. It is agreed that if Buyer shall for any reason fail to take the royalty oil hereunder as and when made available to the Buyer pursuant to Buyer's previous nominations, Buyer shall nevertheless pay Seller as though it had taken delivery of said royalty oil, unless Seller through an understanding with Lessees or the lessees referred to in Articles 2.3 and 2.4 is able to cancel delivery of the quantities called for in said nominations of Buyer. In the event of any cancellation or termination of this Agreement, whether under Articles 10.2 or 10.3, or because of default under this Article XIV or Article 9.6, Buyer shall have an obligation to continue to purchase Seller's royalty oil for up to seven (7) months following termination or cancellation of this Agreement in such quantities as Buyer has elected pursuant to the nomination procedure set forth in Article 2.5 in the six (6) months preceding termination of this Agreement, if Seller is required by the Lessees or the lessees under Articles 2.3 and 2.4 to accept delivery in kind for such period.

14.3 Materiality of Breach. No default or breach of, or failure of performance under, this Agreement shall be deemed to have occurred under this Agreement unless such default, breach or failure of performance is material or substantial under all the cir-

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Not important
What about not meeting time frame under 10.2 (State's legal consultant)

cumstances or involves the non-payment of any sum due under this Agreement which is not the subject of a bona fide dispute.

ARTICLE XV

FORCE MAJEURE

15.1 Relief from Obligations. Except for Buyer's and Seller's obligations to make payment under this Agreement and except for Buyer's obligation to take oil nominated by it, neither party hereto shall be liable for any failure to perform the terms of this Agreement when such failure is due in whole or substantial part to a "force majeure" as hereinafter defined; provided, however, that if an event constituting a force majeure shall prevent substantial performance of a party's obligations hereunder in light of all the circumstances, so as to prevent the party not claiming force majeure from obtaining the benefit of its bargain for a period in excess of four (4) years, said party not claiming force majeure shall have the option to terminate this Agreement. Said option must be exercised before the force majeure ceases to exist. The aforesaid proviso shall not permit the Seller to terminate in the event the force majeure in question is based upon Buyer's inability to obtain requisite state permits, authorizations, or licenses if Buyer has exercised the due diligence required by Article 15.2(ix). Other remedies otherwise available for default or breach in the event of termination after such four year period shall not thereby be affected.

15.2 Definition of "Force Majeure". The term "force majeure" as employed in this Agreement shall mean (i) acts of God;

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(ii) strikes, lockouts or industrial disputes or disturbances; (iii) civil disturbances, arrests and restraint from rules or people; (iv) interruptions by laws, orders, rules, regulations, acts or restraints of any government or governmental body having proper jurisdiction; (v) acts of the public enemy, wars, riots, blockades, insurrections, mobilization; (vi) acts of vandalism or sabotage; (vii) shortages, scarcity or inability to secure labor, fuel, power, equipment or materials (including inability to secure materials by reason of allocation promulgated by authorized governmental agencies), (viii) inability or failure of contractors or subcontractors to perform, (ix) inability to obtain requisite federal, state or other governmental permits, authorizations, or licenses provided the party claiming force majeure has exercised due diligence in attempting to obtain such permits, authorizations or licenses; (x) inability to ship materials because of unavailability of shipping, docking or wharfage not within the reasonable control of the party claiming the existence of a force majeure; (xi) epidemics, landslides, lightning, earthquakes, fire, explosion, floods, washouts, storms, other unusual adverse weather conditions; (xii) breakdowns of machinery, equipment or lines of pipe; (xiii) freezing of wells, pipe lines or other equipment; (xiv) shutdowns necessary for making repairs or alterations to pipe lines or plants, mechanical failure, or the necessity of testing wells, machinery or lines of pipe as may be required by governmental authority or as may be deemed necessary by the testing party for the safe operation thereof whether or not

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of the kind herein enumerated; or (xv) any other event or condition otherwise not reasonably within the control of the party claiming force majeure, whether or not similar to the enumerations of (i) through (xiv).

15.3 <u>Effect of Force Majeure</u>. Upon the occurrence and discovery of an event constituting force majeure, the party claiming that the event is a force majeure shall notify the other party hereto of its claim of force majeure. The party claiming the existence of a force majeure shall, so far as reasonably possible, attempt to remedy such event with due diligence, and the obligations of the disabled party to perform under this Agreement, insofar as they are affected by such force majeure, shall be suspended from the time such force majeure occurs and for so long as the disability so caused should have continued had the party claiming the existence of the force majeure met its remedial obligations under this Article 15.3, and for no longer. The settlement of strikes or lockouts or industrial disputes or disturbances shall be entirely within the discretion of the party having the difficulty, and the above requirement that any force majeure shall be remedied with due diligence shall not require the settlement of strikes, lockouts or industrial disputes or disturbances by acceding to the demands of any opposing party therein when such course is inadvisable in the sole discretion of the disabled party.

Is this standard language "discretion of the party having difficulty"

No need to worry about it

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ARTICLE XVI

NOTICES

16.1 Notices. Any notice, request, demand or statement provided for in this Agreement must be in writing, and may be given by depositing same in the mail, addressed to the party to be notified, postage prepaid, and registered or certified, with a return receipt requested, or by delivery of same in person to such other party. Notice deposited in the mail in the manner hereinabove described shall be effective upon the expiration of seven (7) days after it is so deposited. Notice given in any other manner shall be effective only if and when received by the addressee. For purposes of notice the addresses of the parties hereto shall be as follows:

If to Seller:

State of Alaska
Commissioner of Natural Resources
Pouch "M"
Juneau, Alaska 99811

and
Commissioner of Revenue
Pouch "S"
Juneau, Alaska 99811

and
Director, Division of Minerals and Energy Management
323 Fourth Street
Anchorage, Alaska 99501

If to Buyer:

Alaska Petrochemical Company
601 W. 5th Avenue, #320
Anchorage, Alaska 99501

and
Alaska Petrochemical Company
P. O. Box 6554
Houston, Texas 77005

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16.2 Change of Address. Each party may change its address for notice by giving of notice thereof in the manner hereinabove provided.

ARTICLE XVII

WAIVER

The failure of Seller or Buyer to insist upon strict performance of any provision hereof shall not constitute a waiver of, or estoppel against asserting, the right to require such performance in the future; a waiver or estoppel in any one instance shall not constitute a waiver or estoppel with respect to a later breach of a similar nature or otherwise; a course of performance established by a party shall likewise not estop the other party from complaining of a later breach similar in nature.

ARTICLE XVIII

RECORDS

18.1 Preservation of Records. Buyer and Seller will preserve and maintain all books, accounts and records relating to or arising out of the performance of this Agreement, including but not limited to, the planning, construction and operation of the Petrochemical Facility and the purchase or resale of the royalty oil and its refined products for a period of four (4) years. Buyer will also maintain and preserve all similar books, accounts and records of which it has possession belonging to those third parties with whom it contracts for the performance of various parts of this Agreement. Neither Buyer nor Seller shall be required to retain

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any records for more than six (6) years unless retention of such records is specifically required by applicable law or regulation. Buyer shall either maintain its records within the State of Alaska or make such records available to Seller at Buyer's principal office in the State of Alaska within thirty (30) days after written request therefor by Seller.

18.2 Inspection of Records of Parties. Buyer and Seller will accord to each other and to their authorized agents, attorneys and auditors during reasonable business hours access to any and all property, records, books, documents and indexes thereto directly relating to the Buyer's or Seller's performance of this Agreement and which are under the control of the party from which access is desired so that the other party may inspect, photograph and make copies of such property, records, books, documents and indexes thereto. Notwithstanding the foregoing, (i) Seller shall not be required to disclose any information, data or records which are required to be held confidential by applicable state law or regulation, and (ii) Buyer shall not be required to disclose any information, data or records containing trade secrets which Buyer or its Affiliates, contractors or subcontractors by contract with unaffiliated third parties have agreed to hold confidential. Seller shall notify Buyer of all information obtained, recorded or copied from Buyer's records in order that Buyer may evaluate the advisability of seeking that such information be held confidential by Seller under applicable law or regulation or under the provisions of this Article.

18.3 Financial Statements. So that Seller may be fully informed with regard to Buyer's financial capabilities on an on-going basis, Buyer will provide Seller with a financial statement at quarterly intervals during any periods which Buyer is receiving delivery of oil under this Agreement from Seller. In addition, Buyer will provide Seller with year-end financial statements audited by an independent certified public accounting firm. Preparation of the financial statements shall be at Buyer's cost. Said statements shall be communicated to Seller in the manner provided in Article 16.1.

ARTICLE XIX

RULES AND REGULATIONS; SOVEREIGN POWERS; ENVIRONMENTAL REGULATION AND STANDARDS

19.1 Applicable Laws, Rules and Regulations. This Agreement and the covenants contained herein shall not be interpreted as a limit on the exercise by the State of Alaska of any of its sovereign or regulatory powers, whether inherent or as may be set forth by constitution, statute or regulation, to protect the environment, fish and wildlife, or the health, safety, general welfare, lives or property of the people of the State of Alaska. This Agreement is subject to all present and future valid laws, orders, rules and regulations of the United States, the State of Alaska, or any duly constituted agency thereof; provided, however, that this paragraph shall not be deemed a consent to any attempted alteration, amendment, termination or revocation of the contractual rights, obligations or duties of the parties hereto by the State of Alaska.

19.2 Compliance with State Rules and Regulation. Buyer

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shall comply with all valid and applicable laws and regulations with regard to maintaining the quality of the environment of the State of Alaska, the well-being of fish and wildlife of the State, and the health, safety and welfare of the citizens of the State of Alaska, in the construction of the Petrochemical Facility, the operation and maintenance of the Petrochemical Facility during the term hereof, and with respect to Buyer's purchase, refining and resale of the oil sold hereunder.

19.3 Compliance with Supplemental Environmental Standards. Buyer agrees to comply with the environmental protection standards set forth in Exhibit "D", whether or not such standards are required presently or in the future by applicable governmental law or regulation; provided, however, that the Commissioner of the Department of Environmental Conservation shall possess the power and authority to waive or eliminate any such standards upon a showing of reasonable cause, and provided further that the standards set forth in Exhibit "D" are supplemental to, and not substitutive of, any present or future laws or regulations applicable to regulation of the environment of the State of Alaska.

ARTICLE XX

GOVERNING LAW

This Agreement shall be governed by and construed in accordance with the laws of the State of Alaska, excluding any conflicts-of-law rule or principle which might refer such construction to the laws of another state or country.

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ARTICLE XXI

SEVERABILITY

If any of the terms and conditions of this Agreement are held by any court or governmental authority of competent jurisdiction to contravene or to be invalid under the laws of any political body having jurisdiction over the subject matter hereof, such contravention or invalidity shall not invalidate the entire Agreement. Instead, this Agreement shall be construed as if it did not contain the particular provision or provisions held to be invalid, the rights and obligations of the parties hereto shall be construed and enforced accordingly if feasible, and this Agreement shall thereupon remain in full force and effect.

ARTICLE XXII

AMENDMENT

This Agreement may be supplemented, amended or modified only by a written instrument duly executed by both the parties hereto after proper prior authorization, including approval by the Alaska Royalty Oil & Gas Development Advisory Board and the Alaska State Legislature. Buyer agrees that in the event Article VIII of this Agreement is subsequently amended so as to materially reduce the consideration paid to the Seller, directly or indirectly, for the royalty oil, said amendment will only be effective after it has been approved by a direct vote of the people of the State of Alaska.

ARTICLE XXIII

SUCCESSORS AND ASSIGNS

23.1 General Prohibition of Assignment. Except as otherwise permitted under Article 23.2 no assignment of this Agreement shall be made by either party without first obtaining the written consent of the other party. The Commissioner may grant such consent on behalf of Seller.

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23.2 <u>Limited Right of Assignment</u>. This Agreement shall bind and benefit the parties hereto and their respective successors and valid assigns, but no permitted conveyance or transfer of any interest of either party shall be valid until such other party has been furnished with written notice and a true copy of such conveyance or transfer and an assumption, if any, of this Agreement by such assignee. Either Buyer or Seller, or both, may assign its right, title and interest in, to and by virtue of this Agreement, including any and all extensions, renewals, amendments and supplements thereto to a trustee or trustees, individual or corporate, or to any lender or lenders, as security for bonds or other indebtedness, obligations or securities, without such trustee or trustees or lender or lenders assuming or becoming in any respect obligated to perform any of the obligations of the assignor, and if any such trustee or lender be a corporation, without its being required by the parties hereto to qualify to do business in the State of Alaska (but such trustee or lender shall be required to submit to the jurisdiction of the courts of the State of Alaska for matters relating to this Agreement), and no such assignment shall serve to relieve the assigning party of its obligations hereunder. Any assignment by Buyer pursuant to the next preceding sentence shall be subject to the prior written approval of the Commissioner of any such trustee or trustees or lender or lenders; provided, however, that on or after the date that all the conditions stated in Article 10.2(3) have been fulfilled, no such prior written approval shall be

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required and such assignment to such trustee or trustees or lender or lenders may be freely made. In the event any such trustee or trustees, lender or lenders, or their assignee shall foreclose upon or otherwise assume ownership rights in and to this Agreement, thereupon such trustee or trustees or lender or lenders and their valid successor and assigns (i) shall assume such rights and benefits as well as obligations and liabilities only upon written notice given by it or them to Seller, (ii) shall have the right to receive from Seller, without assuming any obligations or liabilities under this Agreement, except as expressed below in the last sentence of this paragraph, any money or property owed by Seller to Buyer under this Agreement as of the date of such foreclosure, (iii) shall have the right to sell or assign their ownership rights to this Agreement to any person, without the consent of the Seller if such person assumes the obligations of Buyer under this Agreement, and (iv) following such further sale or assignment, shall be relieved of any obligations or liabilities provided for under this Agreement. Nothing contained within this Article 23.2 shall operate so as (1) to terminate or subordinate Seller's security interest in oil, products, proceeds of the sale, (2) to cancel any obligation to provide security as set forth in Article 12.2, until money owed to Seller under this Agreement is paid.

ARTICLE XXIV

EQUAL EMPLOYMENT OPPORTUNITY

24.1 Discrimination. Buyer will not discriminate against

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any employee or applicant for employment because of race, color, religion, national origin, ancestry, age or sex. The Buyer will take affirmative action to insure that applicants are considered for employment, and that employees are treated during employment, without regard to their race, color, religion, national origin, ancestry, age or sex. Such action shall include, but not be limited to, the following: employment, upgrading, demotion, or transfer; recruitment or recruitment advertising; layoff or termination, rates of pay or other forms of compensation; and selection for training, including apprenticeship. The Buyer agrees to post in conspicuous places, available to employees and applicants for employment, notices setting forth the provisions of this nondiscrimination clause.

24.2 Advertisement of Equal Employment Opportunity. The Buyer shall state, in all solicitations or advertisements for employees to work that all qualified applicants will receive consideration for employment without regard to race, color, religion, national origin, ancestry, age or sex.

24.3 Notices to Unions. The Buyer will send to each labor union or representative of workers with which the Buyer has a collective bargaining agreement or other contract or understanding a notice advising the labor union or workers' representative of the Buyer's commitments under this Article and shall post copies of the notice in conspicuous places available to all employees and applicants for employment.

24.4 Inclusion of Equal Employment Opportunity Provisions

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in Contracts and Subcontracts. The Buyer will include the provisions of Article 24.1 through 24.3 in its contracts pertaining to the construction and operation of the Petrochemical Facility and will require the inclusion of these provisions in every subcontract entered into by any of its contractors, so that such provisions will be binding upon each subcontractor of Buyer.

24.5 Cooperation with Agencies of Seller. The Buyer agrees that it will fully cooperate with the office or agency of the State of Alaska which seeks to deal with the problem of unlawful or invidious discrimination, and with all other State efforts to guarantee fair employment practices under this Agreement, and Buyer will comply promptly with all reasonable requests and directions from the State Commission for Human Rights or any of its officers or agents relating to prevention of discriminatory employment practice. Full cooperation as expressed above shall include, but not be limited to, being a witness in any proceeding involving questions of unlawful or invidious discrimination if such is deemed necessary by any official or agency of the State of Alaska; permitting employees of Buyer to be witnesses or complainants in any proceeding involving questions of unlawful or invidious discrimination, if such is deemed necessary by any official or agency of the State of Alaska; participating in meetings; submitting periodic reports on the equal employment aspects of present and future employment; assisting in inspection of the Petrochemical Facility site during and after the construction; and promptly complying with all

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directives deemed essential by any office or agency of the State of Alaska to insure compliance with all federal and state laws, regulations and policies pertaining to the prevention of discriminatory employment practices.

ARTICLE XXI

LOCAL HIRE AND TRAINING

25.1 Local Hire.

(1) Buyer will comply with all applicable Alaska statutes and regulations in effect at the time this Agreement becomes effective as well as all amendments thereto and subsequent enactments, providing for local or resident hire.

(2) In addition, and subject to compliance with other requirements of state or federal law or regulation, Buyer will give preference to hiring qualified and available residents over nonresidents for all work to be performed in the construction, operation and maintenance of the Petrochemical Facility. Buyer shall not discriminate against Alaska residents by differentiating between residents and nonresidents in payment of wages, salaries, fringe benefits and working conditions. Nothing shall prohibit the Buyer from hiring Alaska residents through private sources. However, if private sources are unable to supply qualified Alaska residents, Buyer shall then attempt to seek qualified Alaska residents through the Alaska Department of Labor prior to the employment of nonresidents. The Buyer shall allow said Department of Labor two days, excluding Saturday, Sunday and state holidays, to produce

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qualified resident workers prior to the employment of nonresidents. If suitable resident workers are not provided within the specified time period, the Buyer may employ nonresidents possessing the qualifications necessary to perform the work. Notwithstanding the foregoing, the Buyer may hire nonresidents (i) on an emergency basis for the duration of any emergency, (ii) as casual or intermittent employees if their employment will not exceed thirty (30) working days, or (iii) as specially skilled employees when the Department of Labor agrees in advance that such specially skilled persons are unavailable within the State of Alaska.

(3) Buyer will use its best efforts to incorporate in any and all collective bargaining agreements which it enters with labor unions covering work to be performed in the construction, operation and maintenance of the Petrochemical Facility and associated facilities and operations, a provision or provisions requiring the unions' dispatch procedures be established and operated in a manner which will assure that qualified Alaska residents will be employed to perform said work.

(4) Buyer will incorporate in any and all agreements it enters with contractors and subcontractors provisions requiring the employment of qualified Alaska residents, as set forth in Article 25.1(2), and utilization of the contractors' or subcontractors' best efforts to obtain agreements with labor unions, as specified in Article 25.1(3).

(5) Noncompliance with the preceding covenants of

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this Article 25.1 or of Article XXIV shall be grounds for a complaint which an aggrieved resident or the State of Alaska, on its own motion, may file with the Department of Labor against the Buyer, but shall not be considered a default under Article XIV. Buyer hereby agrees to submit to the jurisdiction of the Department of Labor for purposes of determining whether noncompliance in fact occurred. Said Department shall hold a hearing at which the parties may present relevant evidence and cross-examine witnesses prior to such a determination. Adequate notice thereof shall be given to all parties concerned. Upon a determination that noncompliance occurred, the Buyer shall pay the aggrieved party a sum equal to the amount the resident would have received had he been employed by the Buyer, up to a maximum of one (1) year's salary. If such compliance is determined to have been willful, the Department may award an additional sum up to the amount of the original sum awarded.

(6) For purposes of this Article

(a) "resident" means a person who

(i) except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause, is physically present in the state for a period of one year immediately before the time his status is determined;

(ii) maintains a place of residence in the state;

(iii) has established residency in the state;

(iv) has not, within the period of required residency, claimed residency in another state; and

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(v) shows by all attending circumstances that his intent is to make Alaska his permanent residence;

provided, however, that in the event a final judgment is rendered by a court of competent jurisdiction in the State of Alaska that the one year period stated in Alaska Statutes Section 38.40.090 is unconditional because of the length of time, the one year period stated in this subparagraph shall be reduced to such period as is constitutionally acceptable;

(b) "qualified" means capable, through education, training or experience, of performing the duties and satisfying the usual terms and conditions of the employment, if those duties, terms and conditions meet the reasonable standards of the industry as required of other employees performing the same type of work in the industry;

(c) "willful noncompliance" means intentionally, knowingly, or purposely, without justifiable excuse, not giving preference to qualified Alaska residents in employment covered by this section; and

(d) "noncompliance" means not giving preference to qualified Alaska residents in employment covered by this Article 25.1.

(7) The performance of this Article 25.1 shall not be interpreted to require any action which constitutes the violation of any federal or state law or regulation, particularly those relating to discrimination in hiring.

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✓ 25.2 Local Training. Buyer, in order to effectuate the purposes of Article XXIV and Article 25.1, and in order to insure the maximum practicable employment of Alaska residents in the operation and maintenance of the Petrochemical Facility, shall initiate training programs to provide skilled local personnel and adequately trained residents to apply for permanent employment in the operation and maintenance of the Petrochemical Facility. Buyer shall establish and furnish to Seller its employment requirements for the operation and maintenance of the Petrochemical Facility, including the approximate numbers of employees and identification of the types of skills needed, in sufficient time (but not more than one year) for Seller and Buyer to design and conduct its training programs in the skills required. In pursuing such programs, Buyer intends to and shall seek the support and financial aid of other groups and agencies, to wit: the federal government, Seller, municipal and local authorities, unions, and certain native Alaskan corporations. Seller will provide Buyer with reasonable assistance in the design and administration of the training program. Due to the difficulty of establishing objective criteria to insure that adequate effort has been expended by Buyer and because Buyer expects Seller to join with it in establishing such training programs and obtaining funds therefor from a variety of governmental sources, including Seller itself, Buyer's obligations under this program shall be deemed fulfilled in the event that Buyer has expended $500,000 on such training programs or, in the alternative, that an aggregate of $1,000,000 has

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been expended from all sources (including all federal, private and state funds) on such training programs on or prior to ten (10) years from the Effective Date.

25.3 Infrastructure Development. Buyer agrees to use its best efforts to coordinate construction of the Petrochemical Facility with local municipal and borough authorities in order that development of supporting residential, service and other aspects of infrastructure may be coordinated. To that end, Buyer shall seek to arrive at mutually satisfactory solutions with municipal and borough governments to the perceived heavy demand on the physical plant and services of neighboring communities as a result of the construction and operation of the Petrochemical Facility.

ARTICLE XXVI

MISCELLANEOUS

26.1 Exhibits. Exhibits "A" through "D", which are attached to this Agreement, are by this reference incorporated into and made a part of this Agreement.

26.2 Headings. The headings of this Agreement are inserted for convenience and identification only and are not intended to describe, interpret, define or limit the scope, extent or intent of this Agreement or any provision hereof.

26.3 Gender. Whenever the context requires, the gender of all words used in this Agreement shall include the masculine, feminine and neuter, and the number of all words shall include the singular and the plural.

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26.4 Counterparts. This Agreement may be executed in any number of counterparts with the same effect as if Seller and Buyer had signed one document. All counterparts shall be construed together and shall constitute one and the same instrument.

26.5 Additional Documents. In connection with this Agreement, as well as all transactions contemplated by this Agreement, Seller and Buyer agree to execute and deliver such additional documents and instruments and to perform such additional acts as may be necessary or appropriate to effectuate, carry out and perform all the terms, provisions and conditions of this Agreement and all such transactions.

26.6 Supplier-Purchaser Relationship. Buyer and Seller each agree to take all action reasonably necessary or appropriate to effect the transactions contemplated by this Agreement and each party's performance of its obligations hereunder. In the event that this Agreement is canceled or terminated by any party pursuant to the terms hereof, Seller and Buyer hereby agree to waive any rights which either party may have to a continuation of any supplier-purchaser relationship that may have been established with respect to the State of Alaska royalty crude oil for purposes of any federal mandatory crude oil allocation program. Specifically, the Buyer expressly states and the Seller agrees that the consent given in the immediately preceding sentence is such a consent to the termination of any supplier-purchaser relationship between the Seller and the Buyer which may be deemed to exist

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under the Federal Mandatory Petroleum Allocation Regulations (10 C.F.R., Part 211) as is provided in 10 C.F.R. 211.63(d)(1)(i) of such Regulations. Seller and Buyer also agree that any subsequent contracts for the sale, exchange or other disposition of the State of Alaska royalty crude oil that may be entered into by the Buyer or Seller herein will include the advance written consent of the purchaser, exchange partner or other recipient of the crude oil to the termination of any supplier-purchaser relationship which may be deemed to exist with respect to the State of Alaska royalty crude oil for purposes of any mandatory crude oil allocation program upon the expiration, cancellation or termination of the underlying contractual agreement for the sale, exchange or other disposition of the crude oil or in the event that the agreement between the Seller and the Buyer for the sale and purchase of the crude oil is terminated for any reason, including termination for default as stated in Articles IX and XIV or because Buyer fails to meet its obligations under Article 10.2. Buyer also agrees to include in any contracts for the sale, exchange or other disposition of the State of Alaska royalty crude oil an agreement by the purchaser, exchange partner or other recipient of the crude oil to include identical waiver provisions in all subsequent sales, exchanges or other disposition of the crude oil by that purchaser, exchange partner or other recipient and by any subsequent purchasers, exchange partners or other recipients.

√ 26.7 Reasonableness of Approvals. Buyer and Seller agree

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that as to any approvals or consents required of either of them under this Agreement, except for extensions of time periods under Article 10.2, such approvals or consents shall not be unreasonably withheld.

IN WITNESS WHEREOF, the Seller has caused this Agreement to be executed by its Commissioner of Natural Resources and the Buyer has caused this Agreement to be executed by its President, thereunto duly authorized by its Board of Directors in accordance with the certified seal, duly attested, to be affixed hereto, as of the day and year first above written.

THE STATE OF ALASKA

ATTEST:

______________________________ By: ______________________________

Commissioner, Department of Natural Resources

"SELLER"

APPROVED AS TO FORM:

____

ALASKA PETROCHEMICAL COMPANY

ATTEST:

______________________________ By: ______________________________

President

"BUYER"

I, ______________________________, certify that I am the Secretary of the corporation named as Buyer in the above contract, that

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_________________________ was then President of said corporation; that said Agreement was duly signed for and in behalf of said corporation by authority of its governing body, and is within the scope of its corporate powers.

____
Secretary

(CORPORATE SEAL)

THE STATE OF ALASKA)
) ss.
__________ JUDICIAL DISTRICT)

THIS IS TO CERTIFY that on this ______ day of ______________, 1978, before me, the undersigned, a Notary Public in and for the State of Alaska, duly commissioned and sworn as such, personally appeared __________________________, to me known to be the Commissioner of Natural Resources for the STATE OF ALASKA, and known to me to be the person who executed the within instrument on behalf of the STATE OF ALASKA, and acknowledged to me that the same was signed as a free act and deed of the STATE OF ALASKA for the purposes and uses therein stated.

WITNESS my hand and notarial seal the day and year last above written.

____
NOTARY PUBLIC in and for Alaska.
My commission expires: __________

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THE STATE OF ALASKA)
) ss.
__________ JUDICIAL DISTRICT)

THIS IS TO CERTIFY that on the _____ day of ______________, 1978, before me, the undersigned, a Notary Public in and for the State of Alaska, duly commissioned and sworn as such, personally appeared the President of ALASKA PETROCHEMICAL COMPANY, an Alaska corporation, and known to me to be the person who executed the within instrument on behalf of the corporation herein named, and acknowledged to me that the same was signed as a free act and deed of said corporation for the uses and purposes therein stated and pursuant to its Bylaws or a resolution of its Board of Directors.

WITNESS my hand and notarial seal the day and year last above written.

____
NOTARY PUBLIC in and for Alaska.
My commission expires:__________

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CERTIFICATE

I, ______________________________, President and a member of the Board of Directors of ALASKA PETROCHEMICAL COMPANY, an Alaska corporation, do hereby certify that the following is a true and correct copy of a resolution adopted by the Board of Directors of said ALASKA PETROCHEMICAL COMPANY at a special meeting duly called and held at ____________________, Alaska, on _____________, 1978:

BE IT RESOLVED by the Board of Directors of Alaska Petrochemical Company that the Agreement for the Sale and Purchase of State Royalty Oil between Alaska Petrochemical Company and the Commissioner of Natural Resources of the State of Alaska presented to the Board at a special meeting duly called and held in _______________, Alaska, on __________________, 1978, be and is hereby approved;

BE IT FURTHER RESOLVED that the officers of the corporation be and hereby are authorized and directed to execute said Agreement for the Sale and Purchase of State Royalty Oil in the name of Alaska Petrochemical Company, and all further agreements and instruments that may be necessary or desirable to implement the purposes of that agreement.

____
President

SUBSCRIBED and SWORN to before me this ________ day of _______________, 1978.

____
NOTARY PUBLIC in and for Alaska.
My commission expires: __________

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EXHIBIT "A"

Attached to and Made a Part of the Agreement for the Sale and Purchase of State Royalty Oil dated February 22, 1978, 1978, between ALASKA PETROCHEMICAL COMPANY, an Alaska corporation "Buyer", and the COMMISSIONER OF NATURAL RESOURCES OF THE STATE OF ALASKA, acting pursuant to Alaska Statute 38.05.183, "Seller", With Respect to Certain Royalty Oil Owned and Taken In-Kind by Seller Under the Leases Described Herein Covering Lands in the State of Alaska.

Tract No.	Description (Umiat Meridian, Alaska)	No. of Acres	ADL Serial No.	Basic Royalty	Lessee of Record	O.R.R. Interest	Working Interest Ownership
1	T12N-R11E, Secs. 9, 10	1,280	47445	1/8	Mobil and Chevron		Mobil—50% Chevron—50%
2	T12N-R11E, Secs. 11, 12	1,280	28235	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
3	T12N-R12E, Sec. 7	580	28254	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
4	T12N-R15E, Sec. 23, 24	1,280	34625	1/8	Sohio Petroleum Co.	*	Sohio—100%
5	T12N-R15E, Secs. 21, 22	1,280	34626	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
6	T12N-R15E, Secs. 19, 20	1,225	34627	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
7	T12N-R14E, Secs. 23, 24	1,280	34624	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
8	T12N-R14E, Sec. 22	640	28297	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
9	T12N-R13E, Sec. 19	585	47469	1/8	Mobil and Phillips		Mobil—50% Phillips—50%
10	T12N-R12E, Secs. 23, 24	1,280	47448	1/8	Mobil and Phillips		Mobil—66⅔% Phillips—33⅓%
11	T12N-R12E, Secs. 21, 22	1,280	28256	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
12	T12N-R12E, Secs. 17, 18, 19, 20	2,448	28255	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
13	T12N-R11E, Secs. 13, 14, 23, 24	2,560	28237	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
14	T12N-R11E, Secs. 15, 16, 21, 22	2,560	47447	1/8	Mobil and Chevron		Mobil—50% Chevron—50%
15	T12N-R11E, Secs. 17, 18, 19, 20	2,448	47446	1/8	Mobil and Chevron		Mobil—50% Chevron—50%
16	T12N-R10E, Secs. 13, 24	1,280	25637	1/8	A.R.Co., BP Alaska, Sohio Petroleum Co.		A.R.Co.—50% BP Alaska—37½% Sohio—12½%
17	T12N-R11E, Secs. 29, 30, 32	1,868	47449	1/8	Mobil and Chevron		Mobil—50% Chevron—50%
18	T12N-R11E, Secs. 27, 28, 33, 34	2,560	28239	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
19	T12N-R11E, Secs. 25, 26, 35, 36	2,560	28238	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
20	T12N-R12E, Secs. 29, 30, 31, 32	2,459	28259	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
21	T12N-R12E, Secs. 27, 28, 33, 34	2,560	28258	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
22	T12N-R12E, Secs. 25, 35, 36, N/2 and SE/4 Sec. 26	2,400	28257	1/8	Mobil and Phillips		Mobil—50% Phillips—50%

*See comment on page A-5.

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Tract No.	Description	No. of Acres	ADL Serial No.	Basic Royalty	Lessee of Record	O.R.R. Interest	Working Interest Ownership
	(Umiat Meridian, Alaska)						
52	T11N-R11E, Sec. 15	640	28244	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
53	T11N-R11E, Secs. 13, 14, 24	1,920	28245	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
54	T11N-R12E, Secs. 17, 18, 19	1,840	28262	1/8	Chevron		Chevron—100%
54A	T11N-R12E, Sec. 20	640	28262	1/8	Chevron, Mobil, Phillips		Chevron—33⅓% Mobil—33⅓% Phillips—33⅓%
55	T11N-R12E, Secs. 15, 16	1,280	28263	1/8	Mobil and Phillips		Mobil—50% Phillips—50%
55A	T11N-R12E, Secs. 21, 22	1,280	28263	1/8	Mobil, Phillips, Chevron		Mobil—33⅓% Phillips—33⅓% Chevron—33⅓%
56	T11N-R12E, Secs. 13, 14, 23, 24	2,560	47451	1/8	Mobil, Phillips, Chevron		Mobil—33⅓% Phillips—33⅓% Chevron—33⅓%
57	T11N-R13E, Secs. 17, 18, 19, 20	2,480	28283	1/8	Sohio Petroleum Co.	*	Sohio—100%
58	T11N-R13E, Secs. 15, 16, 21, 22	2,560	28284	1/8	Sohio Petroleum Co.	*	Sohio—100%
59	T11N-R13E, Secs. 13, 14, 23, 24	2,560	28285	1/8	Sohio Petroleum Co.	*	Sohio—100%
60	T11N-R14E, Secs. 17, 18, 19, 20	2,480	28305	1/8	Sohio Petroleum Co.	*	Sohio—100%
61	T11N-R14E, Secs. 15, 16, 21, 22	2,560	28306	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
62	T11N-R14E, Secs. 13, 14, 23, 24	2,560	28307	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
63	T11N-R15E, Secs. 17, 18, 19, 20	2,480	28321	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
64	T11N-R15E, Secs. 15, 16, 21, 22	2,560	28322	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
65	T11N-R15E, Secs. 13, 14, 23, 24	2,560	28323	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
66	T11N-R16E, Secs. 17, 18, 19	1,840	28339	1/8	Sohio Petroleum Co.	*	Sohio—100%
67	T11N-R16E, Secs. 15, 16	1,280	28340	1/8	Sohio Petroleum Co.	*	Sohio—100%
68	T11N-R16E, Secs. 13, 14	1,280	28341	1/8	Sohio Petroleum Co.	*	Sohio—100%
69	T11N-R16E, Secs. 30, 31, 32	1,851	28343	1/8	Sohio Petroleum Co.	*	Sohio—100%
70	T11N-R15E, Secs. 25, 26, 35, 36	2,560	28324	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
71	T11N-R15E, Secs. 27, 28, 33, 34	2,560	28325	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
72	T11N-R15E, Secs. 29, 30, 31, 32	2,491	28326	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
73	T11N-R14E, Secs. 25, 26, 35, 36	2,560	28308	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
74	T11N-R14E, Secs. 27, 28, 33, 34	2,560	28309	1/8	Sohio Petroleum Co.	*	Sohio—100%
75	T11N-R14E, Secs. 29, 30, 31, 32	2,491	28310	1/8	Sohio Petroleum Co.	*	Sohio—100%
76	T11N-R13E, Secs. 25, 26, 35, 36	2,560	28286	1/8	Sohio Petroleum Co.	*	Sohio—100%
77	T11N-R13E, Secs. 27, 28, 33, 34	2,560	28287	1/8	Sohio Petroleum Co.	*	Sohio—100%
78	T11N-R13E, Secs. 29, 30, 31, 32	2,491	28288	1/8	Mobil and Phillips		Mobil—50% Phillips—50%
79	T11N-R12E, Secs. 25, 26, 35, 36	2,560	28264	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%

*See comment on page A-5.

Tract No.	Description	No. of Acres	ADL Serial No.	Basic Royalty	Lessee of Record	O.R.R. Interest	Working Interest Ownership
	(Umiat Meridian, Alaska)						
80	T11N-R12E, Secs. 27, 28, 33, 34	2,560	47452	1/8	Mobil, Phillips, Chevron		Mobil—33⅓% Phillips—33⅓% Chevron—33⅓%
81	T11N-R12E, Secs. 29, 30, 31, 32	2,491	47453	1/8	Mobil, Phillips, Chevron		Mobil—33⅓% Phillips—33⅓% Chevron—33⅓%
82	T11N-R11E, Sec. 25	640	28246	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
83	T10N-R12E, Secs. 3, 4, 10	1,920	47454	1/8	Mobil, Phillips, Chevron		Mobil—33⅓% Phillips—33⅓% Chevron—33⅓%
84	T10N-R12E, Secs. 1, 2, 11, 12	2,560	28265	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
85	T10N-R13E, Secs. 6, 7, 8, S/2 and NE/4 Sec. 5	2,341	28289	1/8	Mobil and Phillips		Mobil—50% Phillips—50%
85A	T10N-R13E, NW/4 Sec. 5	160	28289	1/8	Mobil, Phillips, Chevron		Mobil—33⅓% Phillips—33⅓% Chevron—33⅓%
86	T10N-R13E, Secs. 3, 4, 9, 10	2,560	47471	1/8	Amerada Hess, et. al.		Amerada Hess—27% Getty—30.5% LL&E—13.25% Placid—9.125% N. B. Hunt—6.3625% Hunt Ind.—3.8625% Caroline Hunt Tr.—3.3% Wm. Herbert Hunt Tr.—3.3% Lamar Hunt Tr. Est.—3.3%
87	T10N-R13E, Secs. 1, 2, 11, 12	2,560	47472	1/8	Amerada Hess and Getty		Amerada Hess—50% Getty—50%
88	T10N-R14E, Secs. 5, 6, 7, 8	2,501	28313	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
89	T10N-R14E, Secs. 3, 4, 9, 10	2,560	28312	1/8	Sohio Petroleum Co.	*	Sohio—100%
90	T10N-R14E, Secs. 1, 2, 11, 12	2,560	28311	1/8	Sohio Petroleum Co.	*	Sohio—100%
91	T10N-R15E, Secs. 5, 6, 7, 8	2,501	28329	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
92	T10N-R15E, Secs. 3, 4, 9, 10	2,560	28328	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
93	T10N-R15E, Secs. 1, 2, 11, 12	2,560	28327	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
94	T10N-R16E, Secs. 5, 6, 7, 8	2,501	28345	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
95	T10N-R16E, Secs. 4, 9	1,280	28344	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
96	T10N-R16E, Sec. 16	640	28347	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%

*See comment on page A-5.

Tract No.	Description	No. of Acres	ADL Serial No.	Basic Royalty	Lessee of Record	O.R.R. Interest	Working Interest Ownership
	(Umiat Meridian, Alaska)						
97	T10N-R16E, Secs. 17, 18, 19, 20	2,512	28346	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
98	T10N-R15E, Secs. 13, 14, 23, 24	2,560	28332	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
99	T10N-R15E, Secs. 15, 16, 21, 22	2,560	28331	1/8	Sohio Petroleum Co.	*	Sohio—100%
100	T10N-R15E, Secs. 17, 18, 19, 20	2,512	28330	1/8	Sohio Petroleum Co.	*	Sohio—100%
101	T10N-R14E, Secs. 13, 14, 23, 24	2,560	28315	1/8	Sohio Petroleum Co.	*	Sohio—100%
102	T10N-R14E, Secs. 15, 16, 21, 22	2,560	28314	1/8	Mobil and Phillips		Mobil—50% Phillips—50%
103	T10N-R14E, Secs. 17, 18, 19, 20	2,512	47475	1/8	Amerada Hess, et. al.		Amerada Hess—25% Getty—25% Marathon—25% Placid—7.5% N. B. Hunt—5% Hunt Ind.—3.125% Caroline Hunt Tr.—3.125% Wm. Herbert Hunt Tr.—3.125% Lamar Hunt Tr. Est.—3.125%
104	T10N-R13E, Secs. 13, 14, 24	1,920	47476	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
105	T10N-R13E, Secs. 15, 16	1,280	28290	1/8	Mobil and Phillips		Mobil—50% Phillips—50%
106	T10N-R14E, Secs. 27, 28	1,280	47482**	1/8	A.R.Co. and Exxon		A.R.Co.—50% Exxon—50%
107	T10N-R14E, Secs. 26, 36	1,280	28316	1/8	Chevron		Chevron—100%
107A	T10N-R14E, Sec. 25	640	28316	1/8	Chevron, Mobil, Phillips		Chevron—33⅓% Mobil—33⅓% Phillips—33⅓%
108	T10N-R15E, Secs. 29, 30, 31, 32	2,523	28335	1/8	Sohio Petroleum Co.	*	Sohio—100%
109	T10N-R15E, Secs. 33, 34	1,280	28334	1/8	Mobil and Phillips		Mobil—50% Phillips—50%
109A	T10N-R15E, Secs. 27, 28	1,280	28334	1/8	Mobil, Phillips, Chevron		Mobil—33⅓% Phillips—33⅓% Chevron—33⅓%
110	T10N-R15E, Secs. 25, 26, 35, 36	2,560	28333	1/8	Sohio Petroleum Co.	*	Sohio—100%
111	T10N-R16E, Secs. 29, 30, 31	1,583	28349	1/8	Sohio Petroleum Co.	*	Sohio—100%
		245,767					

*BP Alaska, Inc. owns an overriding royalty interest equal to 75% of all net profits from production between certain levels of oil production.

**This Tract Number 106 was assigned to A.R.Co. and Exxon. Upon approval of the assignment by the Director a new ADL Serial No. will be given to this Tract.

EXHIBIT "B"

Calculation of monthly in value royalty under the Leases and leases (all calculations shall be rounded to the nearest $0.001)

STEP 1: Calculate each producer's weighted average value per barrel at Point of Delivery for all oil sold by each producer during the month, as follows:

Example, Producer Y

(1) Destination	(2) Volume Sold	(3) Sales Price at Destination	(4) Shipping Costs	(5) Pipeline Tariff	(6) Point of Delivery Value	(7) Weighted Average Value
1	2,000,000	$12.500	$ -0-	$4.770	$7.730	-
2	4,000,000	13.370	1.110	4.750	7.510	-
3	5,000,000	13.440	3.830	4.750	4.860	-
						$6.345

Columns 2, 3, 4 and 5 shall be computed from actual data as reported by each producer and filed with the State of Alaska for royalty purposes and severance tax purposes.

STEP 2: The "weighted average value" per barrel of each producer (column 7 above) at the Point of Delivery shall then be used in column (9) below in calculating the applicable in value price for each producer (column 11 below), the weighted average of which shall be the In Value Price to Buyer (column 12), as follows:

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-continued-

Example, all producers:

(8) Producer and Quantity	(9) Wtd. Avg. Value at Point of Delivery (Col. 7)	(10) Wtd. Avg. Price Received by all other Producers	(11) Applicable Price for In Value Calculation	(12) In Value Price to Buyer
X; 4,200,000	$6.920	$6.404	$6.920	-
Y; 11,000,000	6.345	7.003	7.003	-
Z; 500,000	7.700	6.504	7.700	-
Weighted Avg.	$6.542			$7.003

Notes:

1) Values in column 10 are the weighted average of all producers other than the producer for which the calculation is being made.

2) Column 11 is the highest of the values in columns 9 or 10 for each producer.

3) Column 12 is the weighted average of values in column 11.

4) Buyer shall not pay any reimbursable costs under Article 8.2 until such costs are judicially determined as owing.

5) There is no posted price. "Market" or "field" value shall not be used in calculating the "In Value price to Buyer" unless and until the methodology of determining same is judicially decided.

6) Subject to later adjustment under Article 9.5.

AGO 545784

EXHIBIT "C"

FORM OF BOND

The bond shall be in a form submitted by Buyer and shall contain such terms and conditions as are approved by the Commissioner.

AGO 545785

EXHIBIT "D"

SUPPLEMENTAL ENVIRONMENTAL STANDARDS

VESSEL SAFETY AND MANEUVERABILITY FEATURES

1. Buyer agrees that all tank vessels of 1,600 gross tons or more which it owns and operates directly or through an Affiliate in marine transportation of petroleum, while navigating the coastal waters of the state, shall be equipped with the following:

(a) LORAN-C navigational equipment, or better;

(b) two marine radar systems, meeting either U. S. Marine Administration Standards for Merchant Ship Construction (COM-72-11469, Dec. 1972), or Radio Technical Commission for Marine Services performance specifications for a general purpose navigational set for ocean going ships of 1,600 tons gross tonnage and upwards (RTCM-Paper 106-75/EC-167/SC65-191 BRWG-45, or, RTCM-Paper 104-74/ED-140 BRWG 42), one of which must always be in operation, or better;

(c) those tank vessels of 20,000 DWT and over shall have at least one of the radars fitted with a collision avoidance system meeting either U. S. Maritime Administration Standards for Merchant Ship Construction (COM-72-11469, Dec. 1972), or the Radio Technical Commission for Marine Services performance specifications for a computer aided collision avoidance system for merchant ships (RTCM-Paper 171-76/EC-205/SC65-226), or better.

AGO 545786

2. Except for vessels equipped with lateral thrust equipment and astern horsepower equal to forty percent (40%) of rated horsepower, tank vessels of 20,000 DWT or more owned and operated by Buyer directly or through an Affiliate shall be escorted by tugs having an aggregate shaft horsepower equivalent to five percent of the deadweight tonnage of the escorted vessel when navigating between the Alyeska Terminal at Port Valdez and Bligh Reef, when docking at the Alyeska Terminal, and, after the Petrochemical Facility is operational, at the port facility serving the Petrochemical Facility.

BALLAST WATER TREATMENT

3. With respect to tank vessels owned and operated by Buyer directly or through an Affiliate which carry petroleum, Buyer agrees that no ballast which has been placed in cargo tanks or tank cleaning waste-water will be discharged into the waters of the state. All oily water (including, but not limited to, discharges from fuel tanks, cargo tanks, ballast tanks, slop tanks and bilges, which contain oil, grease, refined petroleum products or their by-products, including petrochemicals) discharged from any tank vessel owned and operated by Buyer directly or through an Affiliate in the State of Alaska shall be received and treated by a waste-water treatment facility meeting the effluent limitations specified in the next paragraph.

AGO 545787

4. Buyer will maintain and operate a waste-water treatment facility for the reception and treatment of ballast carried in cargo tanks and tank cleaning waste-water at or near the place where the petroleum will be transferred from the Petrochemical Facility to vessels for marine transport. Water discharged from said treatment facility shall not contain more than 10 parts of oil, grease, refined petroleum products or their by-products, including petrochemicals, per million parts of water, on a weekly (7 day) average. Buyer will consult with the Department of Fish and Game and Environmental Conservation in connection with designing and constructing said waste-water treatment facility in order that the effect of the effluent discharged from the facility on the receiving environment and the fisheries in that environment will be minimized.

PROOF OF FINANCIAL RESPONSIBILITY

5. Buyer will obtain and maintain or cause to be obtained and maintained insurance in the face amount of $20,000,000 or a corporate indemnity or guarantee of performance in an equivalent amount by a corporation or entity acceptable to the Commissioner, for each and every tank vessel owned and operated by it directly or through an Affiliate that calls at Alaskan ports and carries petroleum to compensate third parties for damages resulting from the unlawful discharge of petroleum within or affecting land or

AGO 545788

water within the territorial jurisdiction of the State of Alaska. Buyer will also obtain and maintain insurance for each and every oil terminal facility it owns, operates or controls in Alaska, in the face amount of $100,000 for each facility with a tank capacity of less than 200,000 barrels of petroleum, and in the face amount of $1,000,000 for each facility with a tank capacity of 200,000 barrels or more of petroleum, to compensate third parties for damages resulting from the unlawful discharge of petroleum within or affecting land or water within the jurisdiction of the State of Alaska while said petroleum is being transferred. In the event any other insurance is required by applicable federal or state law to cover the same risks described in this paragraph, the face amount of any such other insurance shall be considered as a part and in reduction of the face amount of insurance required by this paragraph. The insurance shall be issued by an insurer which is either authorized to sell in the State of Alaska by the Department of Commerce and Economic Development, Division of Insurance, or is an authorized insurer listed by the Division as not disapproved for use in the State of Alaska. The deductible provision in any policy of insurance, binder or certificate shall be unacceptable if it exceeds five percent (5%) of the face amount unless the Buyer demonstrates acceptable supplemental coverage or credit worthiness. The terms of the insurance shall provide that termination or cancellation of the insurance, including expiration by its terms, insofar as it relates to the insured's liability arising from a discharge of

AGO 545789

oil within or affecting the land and water within the territorial jurisdiction of the State of Alaska, will not be effective until thirty days after notice in writing has been posted (prepaid and certified) by the insurer to the insured and to the Alaska Department of Environmental Conservation at its office in Juneau, Alaska. Buyer will annually provide the Department of Environmental Conservation (or its successor in responsibility) evidence of said insurance for the respective vessels and facilities and its coverage of said damages during the month of January.

PETROLEUM SPILL CLEANUP AND CONTINGENCY PLANS

6. Buyer shall be responsible for the detection, location, confinement and cleanup of petroleum discharges at the Petrochemical Facility. At least 180 days prior to scheduled start-up of the Petrochemical Facility, Buyer shall submit its contingency plans to the Department of Environmental Conservation for review as being in compliance with applicable law and regulation. The plans shall provide for immediate corrective action in the event of petroleum discharges, including confinement and cleanup. The plans shall include separate and specific techniques and schedules for cleanup of petroleum discharges on land and sea and in lakes, rivers, streams and estuaries, to the extent such water resources are in proximity to the Petrochemical Facility.

AGO 545790

DEFINITIONS

7. In this exhibit,

(a) "discharge" means any spilling, leaking, pumping, pouring, emitting, emptying or dumping;

(b) "DWT" or "deadweight tons" means the difference in metric tons between the lightweight displacement and the total displacement of a vessel measured in water of specific gravity 1.025 at the load waterline corresponding to the assigned summer freeboard;

(c) "oil terminal facility" means an onshore or offshore facility of any kind and related appurtenances, including but not limited to a deepwater port, located in, on, or under the surface of any land or water of the state, including title and submerged land, which is used or capable of being used for the purpose of transferring, processing or refining, or storing petroleum as it is defined in this section;

(d) "petroleum" means all crude oil purchased under this Agreement, and all refined petroleum products and petroleum by-products, including petrochemicals, produced at the Petrochemical Facility from such petroleum;

(e) "tank vessel" means a self-propelled vessel that is specially constructed or converted to carry bulk cargo in tanks and includes tankers, tankships and combination carriers;

(f) "transferred" includes both onloading and offloading between terminal and vessel; and

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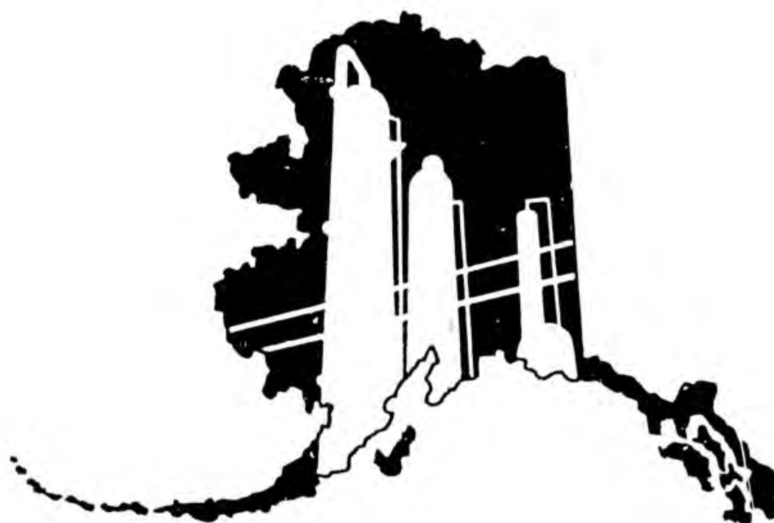
(g) "waters of the state" means the navigable waters within the territorial limits of the State of Alaska, and the marginal sea adjacent to the State of Alaska, as defined in AS 44.03 and AS 46.03.900(22) or any successor provisions.

AGO 545792

PETROCHEMICALS IN ALASKA

THE ALPETCO STORY



ALASKA PETROCHEMICAL COMPANY

March 15, 1978

AGO 545793

FOREWORD

In August 1977 Alaska Petrochemical Company (Alpetco) was one of several companies to submit proposals to the State of Alaska Royalty Oil and Gas Development Advisory Board to purchase the State's Prudhoe Bay royalty crude oil and to use it as feedstock for a refinery in Alaska. Alpetco's proposal involves more permanent jobs and a larger tax base than any of the other proposals. On February 19, 1978 the Governor of Alaska recommended that Alpetco be selected from among four finalists in the competition. On February 22 the Alaska State Royalty Oil and Gas Development Board unanimously approved and Alpetco executed a 27 year contract with the State of Alaska for the purchase of up to 150,000 barrels per day of royalty crude oil. Prior to becoming effective, the contract must be ratified by both houses of the Alaska legislature.

March 15, 1978

Alaska Petrochemical Company

601 West 5th Avenue
Anchorage, Alaska 99501
(907) 272-1517

2200 Post Oak Tower
5051 Westheimer Road
Houston, Texas 77056
(713) 621-8710

AGO 545794

THE ALPETCO CONCEPT

The Alpetco Concept was developed as the foundation of Alaska Petrochemical Company's proposal to the State of Alaska. Alpetco's concept for what is in the best interest of all Alaskans has remained unchanged:

THE ALPETCO CONCEPT

"The State of Alaska has determined to take its one-eighth royalty on the North Slope crude oil 'in kind' rather than 'in dollars.'

There is little justification for the State of Alaska to take its royalty oil 'in kind' unless value is added to the crude product before it leaves Alaska. If the State's crude is to be sold to someone 'as is,' the State may as well take the crude 'in value,' letting the producing oil companies handle shipping and marketing and the State collect its royalty 'in dollars.' On the other hand, if value is added in Alaska then substantial benefits can be created for the State of Alaska and its citizens. The more value added in Alaska, the better.

Assuming the crude oil to be worth $13 a barrel at Valdez, it will be processed further — somewhere — until it has an added value of $30, $50, $100, $150 or $200 per barrel. Adding such values requires plants and payrolls. These can be in Alaska or on the California or Gulf Coasts. Why not in Alaska?

A plant investment of $1 billion or more is necessary to add such values. The property and revenue taxes on this real property will go to the State in which the plant is located. Why not to Alaska?

The jobs and payrolls created by adding these values are permanent jobs and payrolls, not temporary. Why not for Alaskans?

Additional industry will spring up around the petrochemical complex — wherever it is located — to add further value to its wide range of products, thus creating additional permanent jobs and payrolls. Why not in Alaska?

ALPETCO's proposed program will add maximum value to the product, and this value will be added **in Alaska** and **by Alaskans.**"

August 1, 1977

AGO 545795

CHRONOLOGY OF ALPETCO EVENTS

August 1, 1977	Preliminary proposals submitted to the State
October 15, 1977	Detailed proposals submitted
February 17, 1978	Final contract offer submitted
February 19, 1978	Governor Hammond chose Alpetco
February 22, 1978	Royalty Oil and Gas Development Advisory Board voted to accept Alpetco's contract
February 22, 1978	Alpetco contract executed

AGO 545796

WHO IS ALPETCO?

Alpetco is a new company, incorporated in Alaska. It is owned by three shareholders, each of whom is a corporation. Alaska Interstate Company owns 60% of Alpetco; Alaska Consolidated Shipping, Inc. owns 20%; and Barbour Oil Company owns 20%.

Alaska Interstate is a publicly owned Alaska corporation engaged in energy and manufacturing businesses. The company is the only Alaska company listed on the New York Stock Exchange. In 1977, revenues were nearly $190 million. Alaska Interstate businesses include transmission and distribution of natural gas in Alaska (Alaska Pipeline Company and Anchorage Natural Gas, both headquartered in Anchorage); exploration, production and liquefaction of natural gas in Indonesia; exploration and production of oil and natural gas in the U.S.; engineering and construction of gas processing facilities; pollution control and sulfur recovery processes; and manufacturing.

Alaska Consolidated Shipping is owned 51% by six Alaska Native Regional Corporations whose shares are owned by 34,000 Alaskans. The Native corporations owning control of ACS are:

The Aleut Corporation

Bristol Bay Corporation

Calista Corporation

Chugach Natives, Inc.

Cook Inlet Regional Corporation

Koniag Regional Native Corporation

Seatrain Lines, Inc., a major U.S. shipping and shipbuilding company owns 49% of ACS. The stock of Seatrain is publicly owned and listed on the New York Stock Exchange. Seatrain's revenues last year exceeded $400 million. The company is engaged in tanker and containerized cargo transportation throughout the world. Seatrain operates a major shipyard located at the former Brooklyn Navy Yard in New York and has completed four petroleum tankers of 225,000 deadweight tons each. The company also owns a 36,000 barrel per day petroleum refinery in Texas.

Barbour Oil Company, a family owned company in Houston, owns 20% of Alpetco. The late John D. Barbour, Sr., was founder of Alpetco and was the principal of Barbour Oil.

AGO 545797

WHO IS THE MANAGEMENT OF ALPETCO?

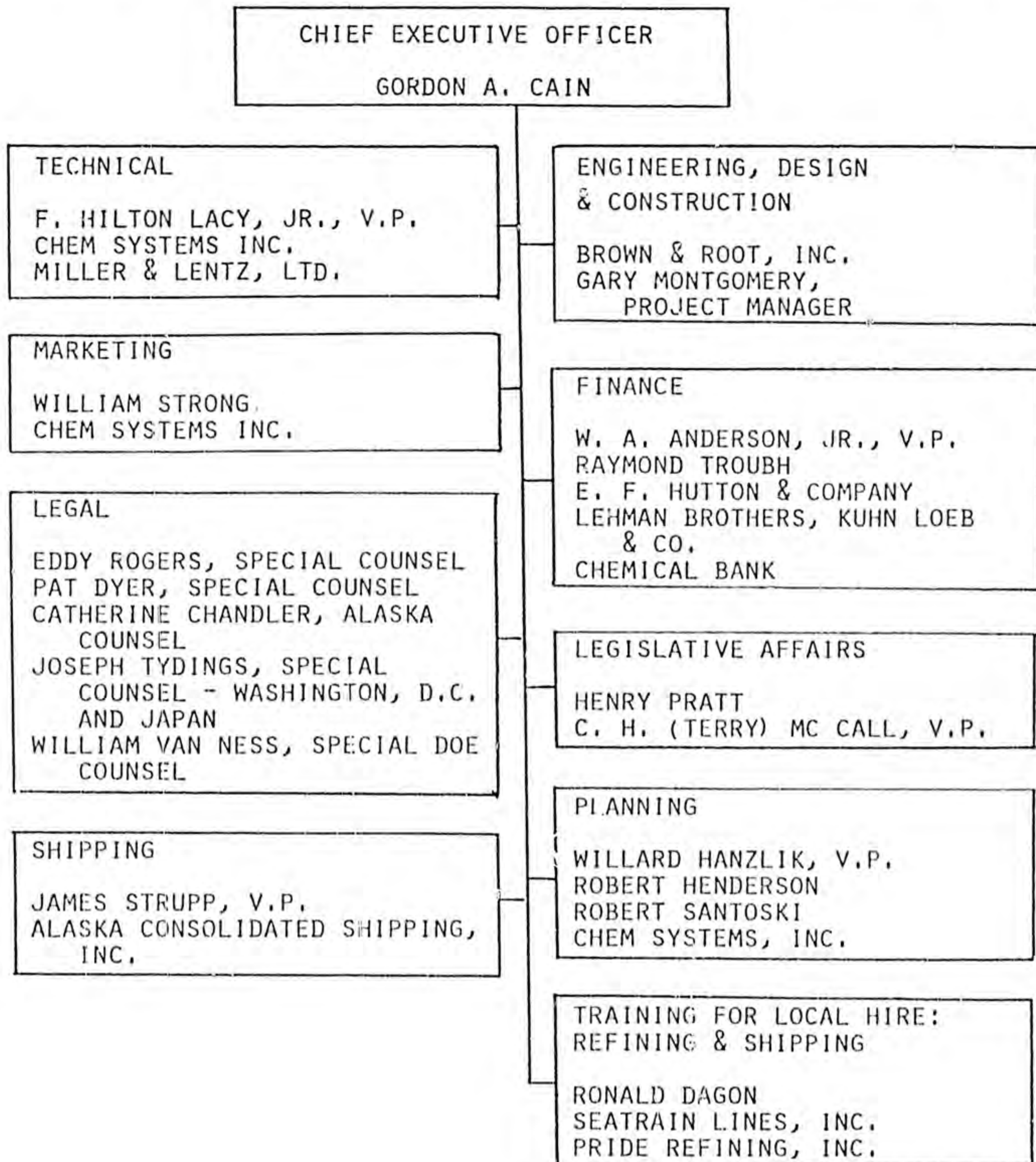
Alpetco is governed by a board of directors and managed by officers elected by the board.

Members of the Board of Directors	Principal Occupation and Residence
O. Charles Honig	Chairman and Chief Executive Officer, Alaska Interstate Company (Houston)
Gordon A. Cain	Chief Executive Officer, Alpetco (Houston)
W. A. Anderson, Jr.	Vice President — Finance, Alaska Interstate Company (Houston)
John Gundersen	Representative, The Aleut Corporation (Seattle)
Willard M. Hanzlik	Vice President, Alaska Interstate Company (Houston)
F. Hilton Lacy, Jr.	Vice President — Special Projects, Alaska Interstate Company (Houston)
Sam C. Oliphant	Retired, formerly Senior Vice President Tenneco, Inc. (Granite Shoals, Texas)
C. F. McCall	Senior Vice President, Alaska Interstate Company (Houston)
James J. Strupp	Vice President, Seatrain Lines, Inc. (New York)

AGO 545798

The following chart indicates the organization and management of Alpetco during the development phase of the project:

ORGANIZATION AND MANAGEMENT – DEVELOPMENT PHASE



AGO 545799

WHO ARE THE EXPERTS ADVISING ALPETCO?

The company has retained experts in four categories: marketing and technical, financial, project management and legal affairs.

Marketing and technical consultants: Alpetco has retained Chem Systems Inc., a leading international firm specializing in the petrochemical industry to work closely in all aspects of planning and implementation of the project. Chem Systems is well known in the industry and includes as its clients most of the world's leading oil and chemical companies. They are experienced in petrochemical project development worldwide, including: U.S., Western Europe, Japan, and the Middle East.

Financial advisors: Two major investment banking firms and a large New York commercial bank have advised Alpetco since its inception. Alpetco's co-investment bankers are E. F. Hutton & Co. and Lehman Brothers, Kuhn Loeb & Co., two of the oldest and most experienced firms on Wall Street. Chemical Bank (New York), the nation's sixth largest bank, is Alpetco's lead commercial bank.

Project Managers: Brown & Root, Inc., the largest contractor in the United States, is Alpetco's project manager. Brown & Root is experienced in all phases of developing a petrochemical project including conceptual planning, design, optimization, engineering and construction. Brown & Root has been closely involved with the Alpetco project since August, 1977.

Japanese and Washington affairs: The Washington, D.C. law firm of Danzansky, Dickey, Tydings, Quint & Gordon is advising Alpetco on matters in Washington and in Japan. The firm represents several Japanese government and industry groups in Washington and is knowledgable in government and industry relations in both capitals.

Department of Energy matters: The Washington, D.C. law firm of Van Ness, Feldman & Sutcliffe is advising Alpetco on matters relating to the U.S. Department of Energy. The firm has obtained a very important favorable opinion from the Department of Energy for Alpetco which will protect the state of Alaska's interests under present federal energy regulations.

WHAT DOES ALPETCO PROPOSE TO DO?

The company will build and operate a 150,000 barrel per day refinery and petrochemical facility in Alaska. The project is expected to require approximately six years to engineer and build; after completion Alpetco will use royalty oil for feedstock during the 27 year term of the contract.

AGO 545800

The proposed facility has not been finally configured because optimum design will be based on a number of factors, such as product requirements of purchasers, location of the facility and availability of other feedstocks. However, in general, Alpetco expects that the facility will make a broad range of petrochemicals including aromatics (benzene, toluene and xylene) and olefins (ethylene, propylene, butadiene). Ultimately Alpetco expects that both high and low density polyethylene, polypropylene and other petrochemicals (e.g. aromatics derivatives) may be manufactured in Alaska at downstream components of the facility.

Alpetco will also make certain fuel products for use in Alaska.

Most of the products from the Alpetco facility will be surplus to the needs of industry in Alaska; therefore, Alpetco is seeking markets outside, primarily the U.S. West Coast and the Pacific Basin including Japan.

WHAT IS THE SCHEDULE FOR THE ALPETCO PROJECT?

After the Alaska legislature approves the contract, Alpetco will have six months to select a site for the facility. During this time engineers and site selection experts from Alaska will thoroughly analyze possible locations from Southeast to Cook Inlet. During the following 90 days, the State will conduct public meetings to discuss Alpetco's site preference prior to approving the site.

Detailed planning will begin immediately upon ratification of the contract. While construction in some site work, including utilities and storage facilities, can be started earlier, construction of the refinery and petrochemical units probably won't begin for at least 30 months after contract ratification. Construction of the facilities will require approximately 3½ years.

DO PETROCHEMICALS MAKE ECONOMIC SENSE FOR ALASKA?

Very simply, yes. Until recently, most petrochemicals have been made on the Gulf Coast with gas feedstocks. Now those feedstocks are becoming more expensive, compared to crude oil, and refining and processing facilities are being built nearer to the source of the feedstocks.

A very large and rapidly growing market for petrochemicals exists today on the West Coast. There is no indication that large world-scale plants are being planned for this market. To supply the West Coast with petrochemical products in the future, more foreign (Middle East) crude oil will need to be shipped to the Gulf Coast for processing into petrochemicals, and then transported again by ship or rail to the West Coast.

AGO 545801

This amount of long distance shipping and multiple handling is very costly. An Alaskan facility will have the advantage of being able to ship petrochemicals directly down the coast to markets in British Columbia, Washington, Oregon and California.

While construction and operating costs will be higher in Alaska than they are on the Gulf Coast, they are expected to be lower than in the Middle East.

Finally, the key to the economics of Alpetco's project is the value placed on a long-term supply of crude oil from a politically secure source, such as Alaska. In the future, particularly in the mid-1980's and beyond, Alpetco believes that Alaska oil will be extremely valuable as a feedstock for petrochemicals.

IS THERE A NEED FOR PETROCHEMICALS FROM ALASKA?

Today, in early 1978, there is a general oversupply of most petrochemicals in world markets. However the outlook for future needs indicates a strong growth in demand, and a need for additional petrochemical capacity in the U.S., particularly to serve West Coast and other Pacific Basin markets.

Future growth rates of basic petrochemicals are expected to remain quite high (5% to 6% annually through 1990) compared to much lower rates of growth for petroleum (fuels) products (.6% by 1990). Chart A shows the expected growth rates for selected products through 1990.

The forecast for basic petrochemicals (ethylene, propylene, benzene) shown in Table I and based on the conservative growth rates referred to above, indicates that Alpetco's production will represent a relatively small share of the industry.

Table I

Forecast of U.S. Demand for Basic Petrochemicals
(billions of pounds per year)

Year	Ethylene	Propylene	Benzene
1980	31	15	13
1990	53	28	21
2000	85	47	33
Alpetco Case LE-1	1.2	0.7	1.0

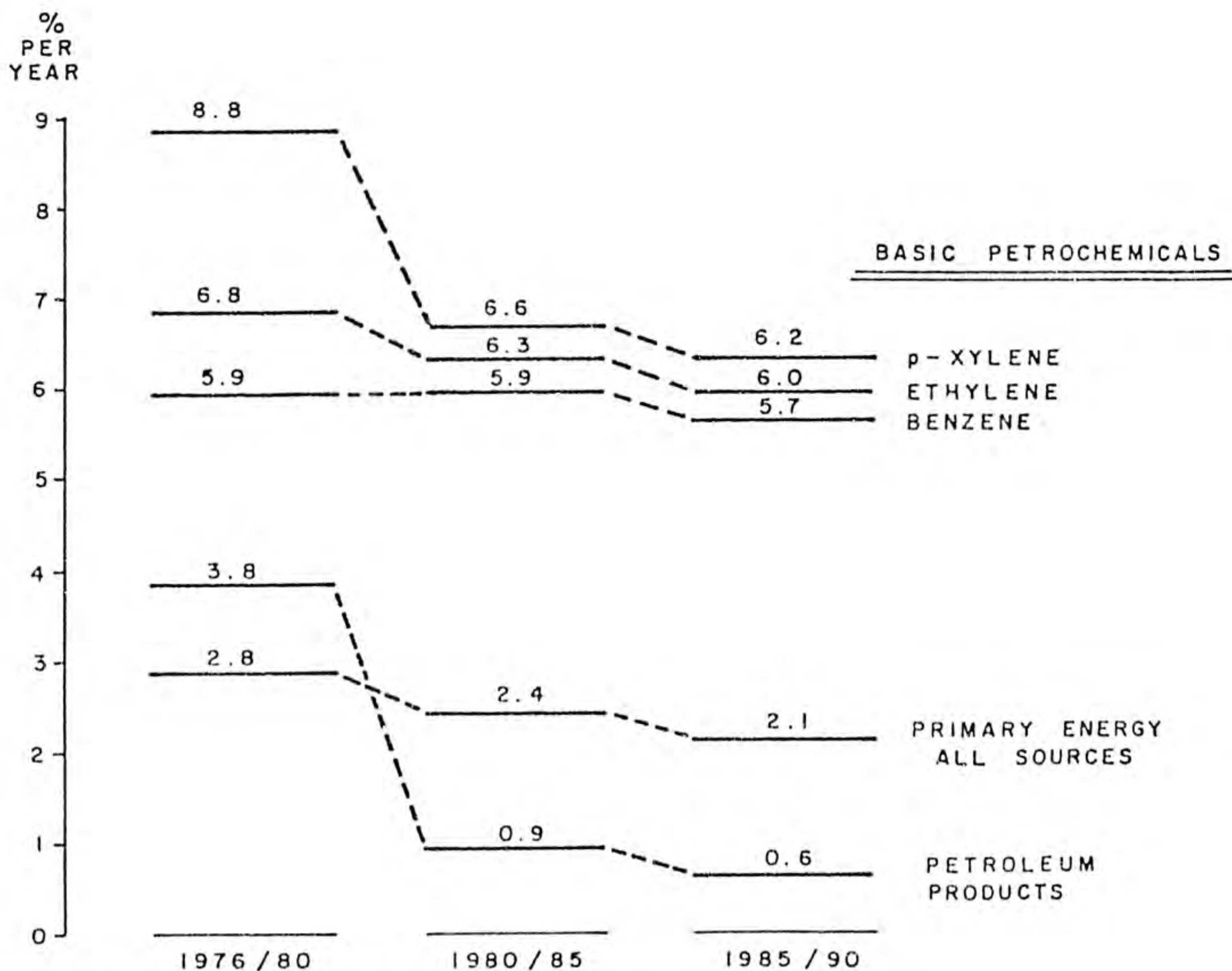
Source: Chem Systems Inc.

AGO 545802

Chart A

FORECAST GROWTH RATES

PETROCHEMICALS VS. FUEL PRODUCTS



Source: Chem Systems Inc.

AGO 545803

The relevant market in the U.S. for Alaska petrochemicals is on the West Coast because this market has lower transportation costs from Alaska, strong growth, and no planned new capacity. In fact, despite the substantial and growing West Coast market for petrochemicals, there are no major existing facilities on the West Coast which manufacture petrochemicals. Chart B indicates that demand for petrochemicals substantially exceeds present supply and this imbalance worsens in the future.

A very conclusive illustration of the need for petrochemicals in Alpetco's relevant market area is shown in Table II below. Alpetco intends to build one "world-scale" ethylene plant while the market will grow to a level requiring ten such new plants.

Table II

New World Scale Ethylene Plants Needed

	U.S. West Coast	Other Pacific Basin
1976-1985	3	2
1985-1990	1	4
	4	6

Source: Chem Systems Inc.

Alpetco initially plans one world-scale plant

Chart B

U.S. WEST COAST

SUPPLY-DEMAND

SELECTED PETROCHEMICALS

	MILLION POUNDS			
	1976	1980	1985	1990
Ethylene for Major Derivatives				
Supply (1)	250	250	250	250
Demand	1725	2435	3455	4500
Low Density Polyethylene				
Supply (1)	120	120	120	120
Demand	710	1000	1400	1900
Styrene				
Supply (1)	0	0	0	0
Demand	500	742	1085	1590

NOTE:

(1) Currently installed capacity only

AGO 545804

WHAT WILL BE THE IMPACT OF THE ALPETCO PROJECT ON THE U.S. AND PACIFIC BASIN MARKETS?

Alpetco's petrochemical output will not represent a significant share of the U.S. and Pacific Basin markets by the time the project is operational. Based on one possible configuration of Alpetco's facility the company would have no more than 3 to 4% of the 1985 estimated market for aromatics (benzene, toluene, xylene) or olefins (ethylene, propylene, butadiene). Further, Alpetco's market share of downstream products would also be quite low.

Table III

Expected Market Share of Alpetco's Facility in 1985

Product	Normal Plant Size	% of U.S. and Pacific Basin Markets
Low Density Polyethylene	600 MM lbs/year	4%
High Density Polyethylene	300 MM lbs/year	3%
Polypropylene	400 MM lbs/year	4%
Styrene	800 MM lbs/year	6%

Source: Chem Systems Inc.

DOESN'T ALPETCO JUST WANT ALASKA'S ROYALTY OIL BECAUSE THERE WILL BE A SHORTAGE OF OIL SOMEDAY?

The contract provides that Alpetco may not purchase any royalty oil unless and until it has obtained financing commitments for $1.5 billion. This is a crucial "benchmark" and is designed to be the "go/no-go" measure in the contract.

The Alpetco contract requires that the company develop a petrochemical facility in Alaska according to a rigorous timetable. Failure to meet each and every requirement gives the State a right to terminate the contract. Alpetco's only reason for purchasing royalty oil is for use in a petrochemical facility to be built in Alaska.

HOW DOES ALPETCO EXPECT TO FINANCE THE PROJECT?

The project will be financed by a combination of bank revolving credit, medium and long-term debt, both taxable and tax-exempt, supplier credits and foreign export bank financing. The long-term taxable debt will be supplied by private placement issues with major life insurance companies, pension and profit-sharing and retirement

AGO 545805

funds. The tax-exempt portion of the project, which could include as much as $350 million, will be placed with casualty insurance companies and commercial banks. The availability of tax-exempt financing is beneficial to Alpetco since it can lower Alpetco's interest rate by as much as 2 percent versus regular taxable debt.

Since the project will be phased, the requirements for long-term financing will be spread out over several years and thus give the institutional markets time to digest the debt. This is the same type of program as carried out with other large project financings common to the financial community.

Alpetco's financial advisors, E. F. Hutton and Lehman Brothers, Kuhn Loeb, have given their opinion that the project is financible and that any needed equity for the project can be raised.

Alpetco as well as E. F. Hutton and Lehman Brothers, Kuhn Loeb expects that several major chemical companies may participate in the project either through purchase agreements, joint ventures or other forms of participation. Such involvement by major chemical firms is quite typical in large petrochemical ventures and will improve the financibility of the project.

Construction financing for the project is being arranged by Chemical Bank (New York). Chemical Bank will be lead bank for a banking group that will provide working capital and construction financing for Alpetco and has already committed $150 million of its own resources towards the necessary debt financing of the project.

WHERE WILL THE STATE SELL THE OIL TO ALPETCO?

At Pump Station #1, on the North Slope.

WHO IS RESPONSIBLE FOR GETTING THE OIL FROM PUMP STATION # 1 TO THE ALPETCO FACILITY?

Alpetco is. Since the trans-Alaska pipeline is a regulated public carrier, Alpetco will deliver its oil to the pipeline companies for shipment to Valdez. Alpetco will pay published pipeline tariffs directly to the various pipeline companies. Alpetco will also be responsible for transporting the oil from the end of the TAPS pipeline to its facility. This will be by pipeline if the facility is in the area of Valdez or by specially built tanker or ocean going barge if the facility is not near Valdez. All costs of this transport will be paid by Alpetco.

AGO 545806

BECAUSE CRUDE OIL WILL BE SCARCE IN THE FUTURE, WON'T ALPETCO BE GETTING A BARGAIN?

Alpetco agrees that crude oil may well be in short supply in the future. It is this fact that makes the long-term contract to purchase Alaska's royalty oil valuable to Alpetco. However, the price Alpetco will pay for royalty oil will always be the same price that the producing oil companies would have paid the State "in value." This price is the same as what the non-royalty oil is sold for in the market place; therefore, the price will always reflect current value of the oil. If oil prices rise in the future, then Alpetco will pay the State of Alaska that higher price. There will never be any "bargain" in price.

WILL ALPETCO COMPLY WITH STRICT ENVIRONMENTAL STANDARDS?

The company has agreed in its contract to abide by all state or federal laws and regulations and in addition has agreed to a number of supplemental state standards, whether or not required by law.

WHAT ARE THE BENEFITS OF THE ALPETCO PROJECT TO THE STATE OF ALASKA?

There are many. The Alpetco project is a unique opportunity for Alaskans to use their natural resource. . .royalty crude oil. . .to create long term and very valuable benefits. No other state has ever had an opportunity so great.

Some of the benefits to Alaska are:

- No risk to the State of Alaska
- No subsidy to Alpetco
- Additional employment
- Additional tax revenues
- Alaska Endowment Trust
- Shipping by Alaskans
- Specialized job training
- Local hire
- Controlled industrial development

AGO 545807

No Risk to the State of Alaska; No Subsidy to Alpetco

Alpetco will not purchase royalty oil unless and until it has obtained financing commitments for $1.5 billion, which clearly indicates that the petrochemical facility will be built.

Alpetco has already received a favorable opinion from the Department of Energy establishing the right of the State of Alaska to terminate sales of oil to Alpetco if Alpetco does not fulfill its contractual obligations. Without this DOE opinion, the State would not be protected because certain federal regulations would have acted to require the State to continue honoring a "supplier-purchaser" relationship. Under the opinion obtained by Alpetco on behalf of Alaska, the State has no risk.

Alpetco and the State have agreed to performance benchmarks which are designed to measure the progress made by Alpetco in building the petrochemical facility. Failure by Alpetco to attain each and every benchmark results in a right by the State to terminate Alpetco's contract. Chart C summarizes the performance benchmarks. The 18 month check point (eighteen months after the legislature ratifies the contract) is the most important one. This is the "go/no-go" benchmark. If Alpetco is unable to put together the project by the 18 month benchmark, the State may terminate the contract.

Additional Employment

The project offers excellent long term employment opportunities for Alaskans. The petrochemical industry provides year around jobs with excellent wages. The many categories of jobs create good opportunities for training and career development.

Preliminary planning estimates for new permanent jobs at the petrochemical facility are shown in Table IV.

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CHART C

NO RISK TO ALASKA: PERFORMANCE BENCHMARKS

Contract May Be Cancelled by State If Alpetco Fails to Attain Each Benchmark as Follows:

Time Period	Required Performance
1st 6 months	Monthly progress reports to the State
Thereafter	Quarterly progress reports
6 months	$2 million invested
	Site selection
	Begin optimization design
12 months	$3 million invested
18 months	$10 million committed
	Contracts for sale of 70% of output
	Get financing commitments for $1.5 billion
	Complete Environmental Impact Assessment
	File for permits
	Finalize plant design
24 months	$100 million committed
30 months	Commence construction
36 months	$600 million committed
48 months	$1 billion committed
60 months	$1.2 billion committed
72 months	$1.5 billion committed

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Table IV
New Permanent Jobs

	Minimum	Maximum
Refining	450	550
Aromatics units	250	300
Olefins steam cracker	300	375
Polyethylene units	400	575
Polypropylene units	250	350
General works management	75	75
Contract help	200	250
Total refinery related jobs	1,925	2,475
Shipping	250	350
Total permanent jobs	2,175	2,825

During the construction phase (3½ years), from 3,500 to 4,000 workers will be needed. Many of these workers will be able to remain as operators and maintenance workers at the facility if they desire.

The shipping activities of Alaska Consolidated Shipping will provide permanent jobs for 250 to 350 Alaskans.

In summary, the Alpetco project is expected to create 2,175 to 2,825 new permanent jobs for Alaska.

Additional Tax Revenues

Because of the large investment in a petrochemical facility, a substantial tax base will be created by Alpetco. The company's financial projections show that an average of more than $49 million will be paid annually to state and local governments by Alpetco. Table V shows the various categories and expected tax revenues from the project.

AGO 545810

Table V
Direct Tax Benefit to Alaska*

	$ Million — Estimated** —	
	Average Per Year	Total Contract Period
Property Taxes (@ 1%)	$23	$ 612
State Corporate Income Tax	23	632
Gross Receipts Tax	3	90
	$49	$1,334

*Does not include estimate of personal income taxes paid by Alpetco employees or any taxes paid by support business or employees of support businesses.

**Source: March 10, 1978 analysis for Institute of Social and Economic Research.

Alaska Endowment Trust

Alpetco's contract provides that beginning with the eleventh year after start-up of the plant, 5% of the company's after-tax profits will be contributed to a charitable trust fund to further social, education, cultural and environmental conditions in Alaska. The Alaska Endowment Trust will be administered by trustees unaffiliated with Alpetco. The company expects that its contributions to this public welfare trust will qualify under present IRS rules as a charitable donation and therefore be deductible for federal tax purposes.

Alpetco believes it is important for corporations to be good citizens and the Alaska Endowment Trust provides an excellent means of contributing to the community.

Shipping by Alaskans

As Alpetco's shipping arm, Alaska Consolidated Shipping will provide specialized ships for transportation of dry and liquid bulk petrochemicals. The activities of ACS will provide career opportunities for Alaskan citizens in the maritime industry. ACS is backed up by Seatrain Lines, Inc., one of the largest shipping companies in the United States. The firm is experienced in all phases of shipping including port management and personnel training.

AGO 545811

Specialized Training for Alaskans

Through its affiliate, Alaska Consolidated Shipping, Alpetco is already training future employees in the shipping and refinery industry. Four Alaska Natives are presently in training, two at the Harry Lundeberg School at Piney Point, Maryland and two at Pride Oil Refinery at Abilene, Texas.

Extensive training programs for Alaskans are planned in all phases of shipping, plant operations, and plant maintenance. These training programs will be coordinated with Brown & Root, Chem Systems Inc., local labor unions and with the State of Alaska.

Labor Policies

Alpetco's project manager, Brown & Root, Inc. will operate in Alaska through its subsidiary, Alaska Constructors, Inc., and will comply with all applicable State local hire provisions.

Alaska Constructors is experienced in working with local unions and subcontractors in Alaska and is well thought of in the industry.

By working closely with local agencies, Alaska Constructors will make every effort to phase construction employees into permanent jobs.

Controlled Industrial Development

The petrochemical industry is clean, environmentally safe, and attracts new businesses that thrive on the foundation which petrochemicals bring to the economy. With a high capital investment per employee, the industry requires skilled, well-educated employees who are responsible citizens and who often are leaders in their communities.

AGO 545812

WHY SHOULD THE PROJECT BE SUPPORTED IN ALASKA?

The following editorial in *The Anchorage Times* clearly stated why petrochemicals should be supported in Alaska.

The Anchorage Times, Sunday, February 19, 1978

Royalty Oil Decision

By Robert R. Richards

THIS WEEK the administration is to deliver to the Legislature its recommendation regarding disposition of the state's royalty oil.

Although several experts have questioned the viability of the four proposals before the Royalty Oil and Gas Development Board, it should be noted that the four bidders have been working closely with the state over the past few months to develop plans that make sense for all parties. Now consultants Bonner and Moore Associates Inc. have concluded that at least three of the four contenders are "fully qualified."

It seems to me that anyone concerned about the stability and long run health of Alaska's economy should give careful consideration to this marvelous opportunity to expand the vertical integration of Alaska's industrial base. Our woefull lack of in-state processing of our resources has contributed to chronic abnormal fluctuations in Alaska's economy. Expanding the manufacturing operations in Alaska will help create a more stable and therefore more socially healthy economy in Alaska.

Additionally, the petrochemical industry brings substantial benefits far beyond those of many other industries. It is highly capital intensive and one of the lowest labor intensive industry of any of our nation's basic industries. Therefore, expansion by the petrochemical industry results in very little population impact. The highly automated petrochemical operation requires very few workers and therefore imposes very little additional burden on public services, such as schools, hospitals, highways, etc.

SO IT IS very clear to see that the petrochemical industry, relative to other potential industries, imposes a very small social cost. But what about the other side of the coin? What does this industry do in the way of creating social benefits?

Again, in this regard the petrochemical industry is a star performer. Its first sociall benefit results from its employing highly skilled, well educated, and high paid employees. These people generally have a high participation rate in community affairs. Their high incomes are taxed commensurately high, and their socio-economic station in life geneally implies fewer social problems in the sense of crime, disease and the like.

The second social benefit emanating from the petrochemical industry is its contribution to creating a more stable economy. The industry is virtually non-seasonal. As we all know, those plants down on the Kenai Peninsula keep producing 365 days out of the year. Alaska's other basic industries, fishing, forest products and tourism, are highly seasonal industries. As a result typically employment in Alaska in January is one-fourth below the level of employment in July. Such seasonality creates all sorts of problems. The expansion of the petrochemical industry in Alaska will help considerably to reduce the overall seasonality of employment in our state.

ANOTHER WAY in which industry employment varies is the swings from year to year. This phenomenon, of course, is referred to as the business cycle. Again, Alaska's fishing and forest products industries are highly cyclical industries. The petrochemical industry, on the other hand, experiences considerably less cyclical fluctuation.

Therefore, the expansion of the petrochemical industry in Alaska would reduce both the seasonal and cyclical fluctuations in our economy, bringing about a considerably more stable employment situation.

The third major social benefit from the petrochemical industry results from the huge taxes and other forms of government revenue generated from this industry. The key factor here is that revenue flowing to both state and local government exceeds by far the additional burden which the industry and its employees place on state and local government. So there are all sorts of excess funds available for the pursuit of a whole array of social objectives: parks, bike paths, better schools, better health care, and on, and on and on.

This then, is what leads me to a very important conclusion which we should keep clearly in mind. It is simply this: because of the huge public revenue generated by the petroleum and petrochemical industries this type of economic growth is not only compatible with, but indeed is conducive to the pursuit of the whole array of our non-economic objectives.

Perhaps I can summarize by acknowledging the general positive relationship between our "quality of life" objectives and our economic development. Here we have the opportunity to encourage an industry which will bring wages, highly skilled, well educated people to stable employment and which manyfold more than pays it own way in terms of social impact. The social and economic attractiveness of the petrochemical industry is self-evident.

Robert R. Richards, an economist, is executive vice president of Alaska Pacific Bank.

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AGO 545813

ARE THE ALPETCO PROJECT AND THE PROPOSED NATURAL GAS PIPELINE IN CONFLICT?

Very simply, no. In fact, if the proposed gas pipeline goes forward and it becomes economically feasible to ship gas liquids down the line for processing in Alaska, Alpetco will be interested to work together with such a project to mutual advantage. This is the kind of cooperative development that has helped petrochemical development on the U.S. Gulf Coast to flourish. Alpetco wants to have the same degree of cooperation here in Alaska.

IS THE "MAKE-UP" PROVISION GIVING ALPETCO THE RIGHT TO PURCHASE ROYALTY OIL FROM LEASES OTHER THAN PRUDHOE BAY NECESSARY?

Yes. A secure, long-term supply of crude oil feedstock is the basis upon which the Alpetco project is built. The economics of this petrochemical plant necessitate an average daily supply of approximately 150,000 barrels and requires a $2.5 billion investment.

Confronted with the fact that the State of Alaska ultimately determined to sell only 85% of its share of Prudhoe Bay oil, Alpetco sought on advice to "make-up" any shortfall by purchasing royalty oil from other leases. Although the State reduced this request for all other royalty oil to be satisfied out of only 70% of other royalty oil, Alpetco's financial advisors have stated that this provision is a prerequisite to the financing.

The shortfall may be a small quantity; it may never be needed. It is, however, necessary to underpin the economics of the project.

WHERE WILL ALPETCO BUILD THE PETROCHEMICAL FACILITY?

The company has not yet identified a site on which to build. Preliminary study suggested that a site on the Kenai Peninsula, near Nikiski, would offer the most advantages to the community and Alpetco; however, the company will conduct a thorough site analysis prior to selecting a site.

Alpetco must choose a site within six months after the legislature approves the contract. Following Alpetco's selection, the State will conduct public hearings to determine local opinion about the site.

Alpetco has not ruled out any sites but will rely on its experts for an in-depth site study to be conducted immediately after legislative approval is received.

AGO 545814

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RECEIVED FEB 27 1978 Department of Natural Resources

February 21, 1978

Frederick H. Boness, Esq.
Deputy Commissioner for
Dep't. of Natural Resources
Pouch M
Juneau, Alaska 99803

Re: State of Alaska w Alpetco

Dear Fred:

I have reviewed the Alpetco draft of February 8, 1978 and revised pages sent to me by Telecopier a few days ago. My principal comments on this amended draft are:

✓ 1. Article 1.1 omits "or direct or indirect common ownership interest".

✓ 2. The first sentence of Article 2.3 covers transportation costs. What about other costs?

✓ 3. Art. 2.4 requires the State to obtain advance written consents from future purchasers. You realize, of course, that the Alpetco interpretation by the D.O.E. does not apply to sales to other purchasers. Individual interpretations will be needed to validate each such consent.

✓ 4. In Article 3.3 (last sentence) the buyer will transport the oil "to the Petrochemical Facility". Since the delivery of oil may start before the Facility has been built, these four words should be deleted.

✓ 5. In Article 5.3, the State agrees to bear the cost of the litigation. Also is the storage capacity to be at the "Point of Delivery" if the Point of Delivery is Station #1?

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6. The last words of the first sentence of Article 6.1 have been objected to several times, but are still there. What happens if the oil does not meet the TAPS specifications? If this happened, then presumably the other 7/8 of the oil would also not meet the specifications, which is hard to conceive, but if it happened, what would we (or the lessees) do with the oil?

7. Article 8.1.1 refers only to one litigation. Suppose other suits are brought to clarify the dispute? Why is only this one suit singled out? (See also Article 9.5).

8. In Article IX reference is made to subsequent adjustments of the price, possibly years later. Does this not require a ruling of the D.O.E. as to its validity, in the light of Mr. Gerarden's statement to Mr. LeResche?

9. Article XII raises the most problems.

(a) I recommend that the following be added (for clarification) at the end of the second sentence of Article 12.1. "***but the said security interest shall attach to the account receivable arising therefrom and its proceeds".

(b) Since we know the TAPS tariffs prohibit liens on the oil, the State must be sure to get written waivers before agreeing to this, otherwise the "purchase money" lien on the oil (which is your principal protection) would be effectively eliminated merely by the posting of a bond for the value of the oil in the pipeline, in accordance with the third sentence of Article 12.1. The agreement purports to re-grant the lien at Valdez, but then it would no longer be a "purchase money" lien and the oil would be subject to all previously filed or possessory liens.

(c) Subdivision (ii) of the third sentence of Article 12.1 raises a different question. The State's lien was intended to cover all oil and all accounts receivable to secure payment of all sums due. This is a form of cross-collateralization necessary to protect the seller. Mr. Rogers has tried to turn this into separate liens on individual shipments (like mortgages on automobiles bought by a dealer). This was not discussed or, I believe, understood by the State. This will be a running account, with payments being made substantially after delivery. How could any payment be traced to any particular oil? I doubt that any records would be kept showing what oil was being paid for each time a payment is received.

Let us assume that the Buyer has received $20,000,000 of oil at its facility and an additional $20,000,000 of oil is

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in the pipeline. The Buyer then sells the oil on hand and pays $20,000,000 to the State, with a notice saying "this sum is in payment of all oil in the pipeline". In that event, the pipeline oil would be free of lien, the previously delivered oil (which had been sold to raise the $20,000,000) would be free of lien (see sentence 2 of Article 2.1), the account receivable derived from such sale would have been paid, and the money would have been used to pay the State. Result: there would be no security for payment of the purchase price of the first $20,000,000 of oil, which remains unpaid.

The entire concept of breaking up the deliveries and payments, of segregating accounts and credits, of individual liens (rather than a total "floating" lien on everything), could make the security provision unworkable, and should be resisted.

(d) The fourth sentence makes no sense to me. If delivery is at Station #1, this sentence should be ~~deleted.~~ Corrected It seems to be in error in view of the fifth sentence which refers to the "next preceding sentence", which must mean the third sentence (discussed above), and not the fourth sentence.

(e) The last sentence of Article 12.1 should contain the usual power of attorney by the Buyer to the Seller, authorizing it to execute in the Buyer's name and file all necessary financing documents. This sentence also ties into the assignment problem discussed below.

(f) The following clarification should be added at the end of Article 12.1: "Proceeds of the sale shall include proceeds derived from insurance or other payments resulting from damage to or destruction of the oil or property covered by the security interest. To secure such payment, Buyer will cause all policies of insurance on the oil or other property to which the security interest attaches, to name the Seller as co-insured as its interest may appear."

10. Article 12.2 no longer refers to a fixed amount of alternative security.

(a) What does "substantially reflect the amounts" mean? Does it mean "be equal to"? Also, why not say it?

(b) More important, if the Buyer owes nothing at a particular time, but is buying $50,000,000 the next month, the security would be zero because the security is only to cover sums "owed", not "to be owed".

11. Article 14.1 (v) should read "bankruptcy <u>or</u> <u>other</u> proceeding".

12. Under Article 14.3 is Buyer's failure to meet the time schedule of Article 10.2 a material and substantial breach?

13. As I told Cynthia on the telephone, Article XVIII should be amended to require delivery of periodic financial statements (not less than quarterly) as received by Buyer. The bank will no doubt have the same requirement, so that should be no hardship.

14. Article XXIII raises questions previously discussed.

(a) If the agreement is assigned to a Trustee (who is not required to "assume" the agreement, <u>e.g.</u>, it need not promise to build the refinery), the Trustee should, at the very least, be required to agree to the security provision and to sign and file necessary UCC-1 forms to evidence the fact that it is holding the assets subject to the State's purchase money security interest. The important question is one of substance: Is it contemplated that the Trustee's lien will be paramount to, or subordinate to, the purchase money lien? If the State comes first, this should be made evident.

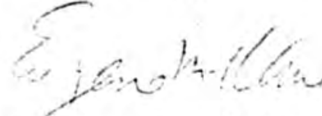
(b) The last sentence of the paragraph makes it clear that the Trustee, on foreclosure of its lien, can assign this agreement to anyone (subdivision iii) without the State's consent. Would it not be embarrassing if the assignment were to a foreign interest which could shut the plant down? Or to a convicted felon? Should not the State have a reasonable voice as to the assignee of its agreement?

15. Article 26.7 again raises the question we have discussed several times: are you prepared to make all decisions justiciable? For example, if extensions of time under Article 10.2(10) are not granted, is this "reasonable"? I asked Mr. Rogers to specify the paragraphs to which he wanted the test of reasonableness to apply, but he retains the over-all approach, and wants the State to be "reasonable" (i.e., subject to court review) with regard to all of its actions. This could bring into litigation, for example, the standards set forth in Exhibit D.

Please call me if you have any questions concerning these comments.

Best personal regards.

Sincerely,



Eugene M. Kline

EMK:blg

cc: Commissioner Robert LeResche

AGO 545819

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... 2 , 1978
Department of
...atural Resources

February 21, 1978

Frederick H. Boness, Esq.
Deputy Commissioner for
Dep't. of Natural Resources
Pouch M
Juneau, Alaska 99803

Re: State of Alaska w Alpetco

Dear Fred:

On rereading my letter of even date, I noted an error. Paragraph 9(d) should read: "this sentence should be corrected."

I suggest that the following be added at the end of the sentence in question (sentence 4 of Article 12.1) to effectuate this correction:

> "*** or prior to the attachment of Seller's security interest thereto upon such delivery."

Since this sentence is not self-operating, I suggest that the following be added: "Buyer also agrees that it will not grant, or consent to, any security interest in favor of any third party, unless such third party agrees in writing prior thereto that such security interest is subordinate to the security interest of the Seller, and unless written proof of such subordination is delivered to Seller prior to the Buyer's granting or consenting to such security interest.

Sincerely,

Eugene M. Kline

EMK:blg

cc: Commissioner Robert LeResche

AGO 545820