

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672

1083 SCOMM 28: JOINT GAS PIPELINE COMMITTEE. 1981-82 1083

they got it out of there but there wasn't a bulk plant in Saudi Arabia.

So you go from that situation where you're building plants and so the cost of construction really includes things that even in Alaska that you take for granted. You've got a railroad here, you've got a road system; you have pretty well established water transportation links. So I don't think you can - I don't think anybody knows. It certainly has cost a lot more to build those plants so far than you'd have to spend in Alaska. But I guess it's a little like doing first thing on the North Slope. Probably those costs were enormous for reasons that no one could anticipate at the time they started.

The more you build there the less the incremental costs mount up. If you talked about a project ten years from now in Saudi Arabia it probably could be done at a reasonable multiple of the U.S. costs. Maybe not too unlike Alaska - but that's just not the case now. But I think those costs, those excessive costs, have been the reason that these projects have been so long to develop. The contract negotiations have just been very very long and tedious because there was a tremendous amount of uncertainty on the cost side that the private company had to be protected on. Down the road, though, I think that the costs in Alaska to build should not be any more than building in the Middle East and I think the costs of operating probably will be less.

LeResche: Don?

Tripplehorn: On a similar line I'm not sure really if this is in your area, but one of the things we asked for and insisted on for a very good reason is the Alaska hiring, the training, and I've not really heard much discussion about what that costs. It must cost something

otherwise presumably these people wouldn't do that if they could find some other cheaper way. I'm assuming that it is very minimal and it would have to be figured in in your estimate for example of operating costs. Do you have any feelings for what an Alaska hire provision costs - is that a significant thing?

Moore: I don't think we addressed the question of Alaska hire versus simply importing personnel, if you will. We just took the cost of what we considered the labor productivity and the wage cost and we made a significant adjustment to these projects to account for higher costs than the lower 48 or the Gulf Coast particularly.

I don't - I really have a tough time answering that question. Usually we do have a lot of experience in these training costs but they are usually in the Middle East and you run into a very high cost of training primarily because you have high turnover. You train five people for the same job. Now if you did not have that problem of turnover in Alaska I wouldn't think the cost of hiring Alaskans would be particularly high. But if you have turnover among people who are trained for industrial jobs who have never worked in industry, they'd rather hunt and fish, they don't like to do that, then you could have a high turnover problem that would be quite disruptive. So I just don't know enough about the labor situation to quantify it although I think that's the main parameter - the cost of training per se isn't going to be particularly high. The consequences of turnover down the road would be quite bad.

Triplehorn: Maybe nobody knows that.

Lyon: Mr. Chairman, our own Department of Labor is having

feedback (unclear) project. I didn't realize ... (unclear)

LeResche: I don't know for certain but I have seen figures and especially on the pipeline in terms of (unclear) very high...

Moore: Those under construction? Training the first guy's not expensive. But training his replacement three or four times - and it isn't necessarily that the cost of training is so expensive it's just the loss of efficiency in operations when you never have anyone on the job who is experienced. It is a kind of hidden cost, it's quite high.

Triplehorn: I'm just curious because we've asked for something and haven't heard any discussion of what - any value on it.

Moore: Well our own experience is in the Middle East we really got hung on a job or we thought it was a simple job and after the third crew of people quit, you know, we finally realized that we were hopelessly overrunning the budget for training people. But it was the turnover problem - it wasn't really the cost per se.

LeResche: Joe, thank you very much. It was a pleasure having you with us.

Moore: Thank you. My pleasure.

LeResche: Okay, let's let the gentleman from Brown & Root address the question.

Norris: (unclear) the labor union. Our own history of training costs at Brown & Root, now addressing ourselves, I'm speaking of construction - recognize you are building a facility in a petrochemical plant or refinery (unclear) hopefully in a place where they (unclear) that's one of the criteria of the pipeline - that there be adequately number of people - construction people - who (unclear) we're also

looking at something that's going to provide permanent jobs - (unclear) you're looking at people locally who want to stay with that company refinery or petrochemicals - it doesn't matter - to allow these construction people - maintenance - a lot of the maintenance activity is the same in construction - not all of it - (unclear) operated it doesn't matter whether you're doing this in the Lower 48 or Alaska you have to (unclear) whether Exxon, or a Texaco, or Shell - you're starting off a new refinery you take a trained contractor - you set him up and (unclear) but you have to replace them train the people they replace. The only difference up here is it's going to take a little longer to train, because (unclear). But I don't see, to answer your question, I don't see that training costs should represent any significant amount.

LeResche: Okay, let's take a five minute break, Marco would like to set up his stuff. I'd like to stand up, too.

LeResche: Come to order Alaska Oil & Chemical - Marco.

Marco: Thank you Mr. Chairman. By now of course we know each other, Mr. Otto Wetzell, Purvin & Gertz, our partner on my right and on my left Bob Hartig, counsel from Anchorage. You're the group that's been saying all along that its quality not quantity you know. I tried to get a few more bodies here. I sent a guy down to the Red Dog and he hasn't come back yet. Neil Bergt, the President of Alaska International Industries, has been in South Africa and is on his way back and hopefully he'll arrive tonight and will be available tomorrow to discuss any issues with members of the Board. Mr. Bud Gertz, Purvin and Gertz is in Cuan Oil, sorry is in Jakarta and could not be back for this meeting but he hopes to participate at a future time if the proceeding allows.

Members of the Board, we were prepared to come before you today and make the affirmative case for Alaska Oil & Chemical's proposal. However, we see a steam roller here with the Alpetco proposal. I believe that our own interest and the public interest can be mutually served by joining the critical issues right away. We invite comparison of AOC's proposal with theirs as we go along. I was pleased that Mr. Moore made the comparison in his presentation just preceding that the game plan of Alpetco and Alaska Oil and Chemical is substantially the same.

We've identified two critical issues at this point we'd like to bring to your attention. First, since the original solicitation was style and I quote "offer for negotiated sale of Prudhoe Bay royalty oil, 150,000 barrels per day," and we have not been notified to the contrary we've been laboring under the notion that we were bidding solely on the royalty share of the Prudhoe Bay unit. However, the recommended contract commits the State in addition to delivery 85 % to 90% of the Prudhoe Bay royalty oil, to grant the right of first refusal for 90% of any other royalty oil the State may wish to take in kind from leases elsewhere in the State. So that's been changed to 70%. That's 70% of other royalty oil from leases elsewhere in the State.

Furthermore, if the above sources are not sufficient the contract binds the State to take in-kind sufficient oil to provide the facility with 150,000 barrels per day from any State lease. The State therefore is not selling Prudhoe Bay royalty oil alone, but is agreeing to supply 150,000 barrels per day for 27 years and subordinate future leases to this proposed contract. We think it's a good deal,

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for Alpetco. We think it's a lousy deal for the State of Alaska.

The second critical issue is the provision that in the event it appears a subsidy may be necessary after 18 months of study, the Governor will accede to the request for a subsidy if a referendum approves. Now this is surprising because of the insistence with the other applicants that the in-valued price is inviolate. It is all the more surprising because of the tacit admission that there are doubts about the ability of the proposal to meet the in-value price. And it is further surprising because we believe the Governor would not recommend a contract that he could not wholeheartedly support.

We come to compare the recommended contract with AOC's contract so we have to compare the recommended contract with AOC's contract in which we abide by the in-value guideline to the extent that it would appear a subsidy is necessary then the State has the unabridged unilateral right to terminate the agreement.

One other noteworthy point is that the Alaska Oil & Chemical's proposal would return a great share of revenue to the State than the recommended proposal. Under our pricing mechanism we turn over all proceeds to the State minus cost and a modest return on equity, which is 20 percent. Or looking at it another way, our return is 3 percent on total capital employed. We believe this is the most conservative earning level of any of the proposals. It is the minimum required to attract capital.

Members of the Board we want to reiterate that implementing the proposal that would be in the best interests of Alaska has been our goal from the start. We believe that ours is a better deal for you.

But if after the scrutiny, after your scrutiny of the information we've provided you still believe that the Alpetco contract is better, then we submit for the record right now that we too will submit the very same contract to you under our name and ask that you consider it on a fair and equitable basis with the other contracts before you, and that you recommend it for the Legislature for ratification. To emphasize again, our contract is better. But if you want to dispose of more than the Prudhoe Bay unit share, and retreat from the subsidy prohibition, then we are willing to let you do so. We did not know until we recieved the Alpetco contracts 36 hours ago that the State was willing to do this.

Now let us provide some evidentiary support for our position that ours is the most feasible of the proposals you have before you. Feasibility rests on the amount of oil committed to the project. The project is financed against the amount of committed oil. Legally, we say, the State is committing 85% of its royalty oil from Prudhoe Bay. We've examined eight estimates of the proven Prudhoe Bay reserves to determine how many barrels there are to finance against. The result is that the 85% share of State royalty oil is not sufficient for any of the proposed contracts. Under the most optimistic forecast which is the one we worked up ourselves. There is only an average of 114,000 barrels per day of crude supply over a 16 year period. The Van Poolen case (3a) provided to us by the State provides a forecast of about 85,000 barrels per day. (Unclear) No, we'll get to that in a second. The Van Poolen case (3a) is a 85,000 barrels per day and these are the figures that the State provided to us. I want to emphasize again that we looked at eight estimates, and we'll show you each of them graphically, and

I'll ask Otto to explain the graph. I'm sorry we don't have some kind of a screen where we could show it to everybody.

Wetzel: I can explain the graph briefly if I may. This is the Van Poolen case (3a) modified by Bob LeResche's letter of February 1st. Simply one year (unclear) the problems that Station 3 (unclear). What we have shown on here on the left hand side is a producing rate which does go to a million and a half barrels a day which exceeds present pipeline capacity. We recognize but nevertheless that is the forecast. We've also shown down here the royalty oil in blue and 85% of the oil is in the orange. For your information we have shown start up at the end of 1982. According to the figures about 40%, another 40% of Prudhoe Bay oil will be gone at the time a plant could start up. This caused us some concern.

Now I might say that when this became apparent to us we immediately (unclear) Prudhoe Bay oil only concerned ourselves with problems and began checking into all of the available estimates that we could find. This graph is somewhat cluttered but we have the estimates on here, but again, let me explain along the left hand side we have the producing rate again in barrels per day and this is for 85% of the Prudhoe Bay oil pursuant to the various forecasts. It obviously all have the same general shape. I might just identify a few of them. Van Poolen is again shown in the blue and this is for 15 years I might add of operation. The ARCO, SOHIO, Mobile oil under FPC filings obviously are somewhat dated, however, they were put in (unclear). We've got two estimates from the Department of Natural Resources. So called reasonable, so called conservative. These are shown in green and orange, The reasonable

again assumes that you will see the pipeline expanded to a million and a half barrels a day. The orange assumes the pipeline does not expand. And as you would expect, you can produce less during the peak years it extends the life. The State termed these and we developed our own forecast which they're documented to., Commissioner. Which is based the assumption that we think is reasonable at this time that some additional oil will be discovered. Either extensions of an existing field or adjacent field which logically could serve such a facility. We also did some digging and got some information and additional opinion from people we respect about what is likely to happen and we have modified the very rapid decline that occurs in all the forecasts except ours in what we label confidential. To reflect this additional information. In effect what we have assumed is a 7% per year decline rather than a rapid decline that is indicated on everybody else's forecast. We think that there is a reasonable balance that prudent businessmen at the present time investigate the probabilities.

Now over this I am putting an overlay which shows a proposed requirements. The lowest, of course, is ours which is a 100,000 barrels per day, next is 150,000 which is Alpetco, as you can see, and then we have Petrofining here. Now we thinking we were bidding on Prudhoe Bay oil alone, abandon this and this brought us back from our interim look of 150,000 barrels a day and the more modest 100,000 barrels a day petrochemical refinery. And it turns out that on our forecast we have about ten years of oil supply after the plant starting. We think that's frankly on the lower end of financibility based on our experience with financing other projects, but nevertheless, we think that during the development phase that we get more detailed information to substantiate

this.

Now, we look at the other proposals and being perfectly obvious to us why Alpetco has obtained in their contract presumably the right to take additional oil, because under any of the forecasts they began to have less than 150,000 barrels a day of oil from Prudhoe Bay in five or six years and actually if they take longer than the end of 1982 to get their facilities they'll have less oil from Prudhoe Bay. So, I can appreciate that they were to appear successful in negotiating their 23 year supply 150,000 barrels per day of oil that 150,000 is reasonable. Petrofining has made no bones about having to get additional oil and of course their problem is unaccountable.

Now, this is what we have based our proposal on. We think it prudent looking at Prudhoe Bay oil alone. We think the State can seriously look at prudence of encouraging a larger facility to be built at this time. We heard Joe Moore say that 100,000 barrels a day short of the lower limit size on a petrochemical refinery. We agree to that. That we should world scale size ethylene plant and other plants. We think its a reasonable size petrochemical plant and we have based all our contract, development of our contract, projections that we have made available and will make available to you on this basis. Wouldn't you like to proceed now?

Pignalberi: One other comment, the Bonner and Moore economics assume full loading of the respective plants for their amortized life period. But the oil just isn't there. To the extent that supplemental supplies are available from the producers we need less than the other applicants worth. Supplemental supplies which are questionable for

them are bonuses to us. They are necessary for the basic feasibility of the other projects and when we translate shortfall crude supply to the deemed economic price that the applicants can pay for the oil they all prove to way under the in-value requirement. Mr. Chairman and members, I think that this summarizes the two critical issues and we may stop the conversation at this point.

LeResche: ny questions from the Board?

Lyon: That's in the absence of any possibility of supply from other sources a supplemental supply.

Pignalberi: I am sorry Dick, I was thinking I wasn't listening.

Lyon: We all have that problem. I so seldom think that it doesn't hit me very often.

Lyon: Looking at the 85% of the share. Now here again. Now if you had that plotted against the total field production - the crude would be up in there somewhere.

Pignalberi: That's correct.

Wetzel: We were under the impression we were making a proposal to buy Prudhoe Bay royalty oil.

Lyon: You are also making a proposal to build a refinery?

Wetzel: That's correct.

Pignalberi: Did you want to touch on some other issues?

LeResche: The Board has other questions. Don?

Triplehorn: If what you say is true then I assume with the same information then any project would prove non-financiable. Is that what you're saying?

Pignalberi: Well, it certainly depends on the size and we

think that our approach from the start has been the most modest, the most conservative. With our size client you meet the threshold of economic feasibility earlier than the others. All the plants, assuming you have a comparable management, comparable technology available to anybody that puts up a plant. That the economic threshold of feasibility, you assume by that time its going to cost you less - ours is that way. And I think our proposal in this respect and all respects has been constant since we first proposed it, however, we probably have not done a very good selling job. I'm told that many people still don't understand it and probably because of its basic simplicity. You know, its the old story about an expert is anybody that is more than fifty miles away from home. And maybe the problem that our proposal is that Alaskans' don't have the same or of hokes pokus to other Alaskans as the people from outside. (unclear)

Warwick: Marco, you said that you would also sign this.

Pignalberi: Andy, we'd be glad to sign it but I have to tell you that I know I thought that what the tenants - the basic philosophy was of the administration we both served in. And.. we tried to develop a proposal that was going to meet the basic concerns of a conservative approach to this kind of development. And, we think ours is still more conservative, and its better and its a sounder business plan than is the proposal thats been recommended to you. But if you want to give something away we just wish you would have made it -- wish you would have let us all know that we could have bid on something more. We'll sign it today.

Warwick: Well, I've... Maybe I don't understand the proposal but I've endeavored to read the very document that you've submitted to

us and basically your proposal is involves the State sharing in the risk of the operation of the facility then. Personally, I question that involvement with government -- that I question the government participating in a venture such as that.

Pignalberi: Andy I think that's a misinterpretation. I don't know how it stems, but you see under our proposal you have that 18 month project implementation period. We go out and put the deal together and in cold hard numbers with contractual obligations from the off-take purchasers and the estimates from the design engineers. We come back and give you the final comprehensive package. You're going to take a look at that package and you're going to see well this is going to require a subsidy or maybe there's some other intolerable condition involved, and you have the unilateral authority at that time to send us packing. We don't ask the State to take risk in the operation - you make the decision 18 months down the line after your dealing from a position of certainty with regard to information as to whether or not it's deemed in the State's best interest to go forward or not.

Warwick: I know what you're saying, but still there is an element of risk. Now, granted some point time 18 months the State ought not to take that risk, but if it does, 18 months from now, if you say no, we're not going to take it, if you not going to take it, we're 18 months off -- 18 months worse off than we are now.

Pignalberi: I would have to ask you to compare that with the other proposals we have recommended to you. The difference being that you have the unilateral right in our case and the other case you have a referendum.

Wetzel: Let me respond another way if I could. Had we got into the development of this, found that the 150,000 barrels a day that was styled on the original application, we could see the 27 years. Our proposal would have been completely different. But as we were looking at Prudhoe Bay, what was offered for sale, we had to frame something that fit what was available. And, that's why we can say today, we'll sign that contract. It's a better deal. But we got all those profits in the those good years that Joe's talked about, Pete's talked about and Gordon talks about, in all those good years we got all the profit - except 5%, which we give to the State. On our proposal if those good years come about and a lot more oil's available, the State gets the profit.

Warwick: I am not so sure those initial years are going to be good years. You know that's where the State's saving the rest. If we're into it that far with you you know we have a substantial decision to make whether or not we want to continue that risk. A private concern into that far you know they have to make a judgment decision. Do we want, do we have in this case, we have 10 million dollars committed. We want to take the next step which will lead to 100 million.

Wetzel: But it's different if you got to be looking at that point in time at another 20 years supply of 150,000 barrels a day of oil. Then if you're looking at a ten year or we're looking at a ten year - even if you say yes.

Warwick: It's my personal philosophy that the State is not in the position. It does not have the staff to make those judgment decisions. The government is supposed to provide essential services that the public

can't provide for themselves...as not to make a decision whether or not to get into the refining, petrochemical business.

Wetzel: Once you exercise the right to take in kind you're in that position.

Warwick: We don't intend to do anything different than we're doing right now - other than to promote petrochemical industry in the State of Alaska. We're taking in-value. This is to me no different than taking in-value. You lose nothing.

Wetzel: That's fair enough. And had that been the decision, we discussed this with the Governor, if that is the decision to get to the same point in 18 months. The qualifications of the people proposing this for all practical purposes, your consultants have told you is the same. You get to that same point at the end of 18 months now. And that was fine as long as there was not this option for the referendum.

Pignalberi: Does the same question exist in your mind about both proposals, or am I missing the distinction that you're making? The question is whether or not the State should be in the business or have to make that decision 18 months down the line. Do you see that as existing in our proposal and not in Alpetco's proposal?

Warwick: In your proposal I see the State initially not receiving the end value price, cost... possibly. We don't know. It's uncertain. And the Alpetco proposal I see that if the facility is hopefully filled, I see they need assured the in-value price.

Pignalberi: The ultimate economics of their proposal - they're not going to know until 18 months down the line. We're willing to make that provision identical to their's. It's your choice. If you

want to give that to us we're happy to take it.

Gallagher: We're dealing basically with three of four groups out of the proposal groups. The other one is based on (unclear) when you're dealing with promoter groups you want to know who believes in what they're doing. Alpetco plans to spend ten million dollars in 18 months. AOC plans to spend 500,000 creating a commitment there (unclear)

Pignalberi: I'd have to ask you to take a long look at what's going to be accomplished in that 18 month period rather than the number of dollars throw at it. And, for one thing its a commitment of ten million but its an investment of three million so we're looking at three million to a half a million and I think we'd have to get in and actually talk some details about what would be accomplished in that 18 month period - and maybe we're better businessmen.

Hartig: I think you'd have to look from what they've promised to do in that 18 months and it says the first 18 months that they will spend and look and see what those projects cost to include includes sewer system, water systems, pollution control by municipalities. I mean I think that needs to be brought in if you're going to accept that. And then it says that they will spend or commit and you can put that on land itself that could be of that value.

Gallagher: They're willing to risk \$10 million in 18 months and you're only willing to risk \$500,000.

Hartig: We're being realistic though. That's the problem that's hurting us.

Wetzel: But also, you have committed the State's oil. You've committed 25 years, 27 years of oil to the project where as here there

isn't 27 years of oil. Prudhoe Bay is going to be down to nothing in 27 years.

Hartig: Obviously if we had the 27 years' supply and a guaranteed supply of a 150,000 barrels a day, which they have - which we didn't have - we could make a lot of concessions, too. But unfortunately we weren't bidding on the same contract. We didn't find out 'til last night.

Pignalberi: You seem to be more concerned about the number than what's going to be done.

Gallagher: Well what are you going to do if one company is willing to go out and spend \$10 million (unclear)

Pignalberi: I say take a careful reading of what's in our proposal and what's in their proposal. As I say, we're willing to sign that contract today. If you're so enamored of that provision, Sterling, we're ready to sign.

Gallagher: (unclear) You say you're going to go out and put it together - one group is willing to put up \$10 million in that amount of time and another \$500,000.

Hartig: Same contract, will be the same. Same contract with 27 years, with a guarantee of 150,000, with a call and we'll give you the same contract and we'll sign it right now. And, in fact, we assume that that offer is there and we hope that we can assume then that you have before you not only our original proposal but you now have another contract before you that we're willing to sign. I agree that the Governor hasn't sponsored that one, but we have now placed it before you and we want you to consider it, when you consider all the rest of them.

LeResche: Dick?

Lyon: I may have misunderstood - seems like it started yesterday when we were talking about was giving each applicant an opportunity to present the essence of the case rather than the essence of the other group's case. So I have - you are presenting it the way you're looking at it or the way everybody seems to be looking at it. I'd like to hear 1/4% of what's, what there is if you have a ...

Wetzel: Mr. Lyon, I think that that's certainly right except we were not bidding on the same thing. We were asked to bid on Prudhoe Bay royalty oil. That's what we came here to bid on and we find that a decision has already been made and I think, Bob didn't you say that you'd signed the contract already?

LeResche: If I did I didn't mean it. I intend to sign the contract.

Wetzel: Well, permitting there's less than half of the oil that's going to go to their refinery that comes from Prudhoe Bay, now we're not bidding on the same thing. Obviously they were bidding on a Cadillac and we were bidding on a a Chevrolet -- and I think that that has to be put on the record that we did not have the opportunity of bidding on the same thing. Does that answer your question.

Hartig: I was going to say, just for the matter of economics -- if you're able to call on oil, future oil on the Kenai Peninsula, you've eliminated transportation costs from Valdez to Kenai, and I think that's a major consideration, of course in our proposal, it depletes this cost. That gives you some idea of what your talking about per barrel.

Wetzel: We have, in anticipation of this meeting, which I thought was going to be held before a decision was made, in which I felt and do feel would have been the proper approach - we prepared a document which we felt addressed the issues that were at hand. And I would like to just list what the issues are, and we will pass out this document. I must say that in passing this document out, it was not prepared in consideration that we had the option to bid on more oil than Prudhoe Bay oil, that it was being even offered for sale. To our way of thinking, if you limit yourself to the Prudhoe Bay oil there are five issues that must be addressed. And again, if you put your blinders on and say we're talking about Prudhoe Bay oil only. The first one that we have discussed and (unclear - tape runs out) ...and assuming that's in the affirmative, and we think it can be done with the 100,000 barrel a day unit, how should Alaska use this short term bonanza - and it is short term if you look at any of those graphs and I am talking again only of Prudhoe Bay. You can take the money and run or you can encourage the establishment of some sort of manufacturing facility.

The third item, the third issue is should the State encourage establishment of the fuels refinery or petrochemical plant. We think the latter.

Four, should the State make a final decision now? And we say, no and we don't think under the contract that you have in front of you now that decision will be made final. It happens to be under their proposal in their hands not in yours. Whereas in our proposal we left that decision to you.

And five, are the guidelines set forth in the Board's Policy

Statement realistic. We think guidelines are great, starting out, but it's obvious that at least one of the guidelines has now been construed as perhaps being overly restrictive, which since this was published before we knew about that we can speak clairvoyance that are willing to allow a referendum in the event they come back and say, sorry fellows, we can't quite make it.

These are discussed in here as are the economics of our proposal based on Prudhoe Bay oil. We think that one of the options that obviously was before the Commissioner was to look at this carefully, particularly in light of what the Governor has said and what is now included in the existing contract.

I think that's all I have, I'll pass these out to you for the Board's use.

LeResche: Anymore questions?

Triplehorn: Mr. Hartig, the question of how long have you been counsel for AOC, all along or if not when...

Hartig: I think that it was October, wasn't it. I think around October. End of September. September, October.

Lyon: Are you currently with GVEA - it has nothing to do with this application.

Hartig: No I'm not involved with them in this area, no. I would probably still represent them.

Lyon: We're not trying to limit your practice. (Laughter)

Hartig: I think as another matter to this (unclear) I think there has been some communications from the Commissioner to AOC, of

which we received at a late date in the week but there has been no opportunity to review or to respond and we would ask the Board if we could try and do it verbally here. But, it would be make shift but we would request that we have some time to respond because I think these are serious points that have been raised by the Commissioner with regards to our response to his offer; and we feel that they were not proper, that they're not correct and we certainly want the opportunity to respond to them and have the Board aware of that because as it stands now, the letter in the file, in your file, really makes us look pretty bad. So we would ask that - to have that opportunity sometime to have the record remain open so that we can respond to it. And, also to the contract itself. As I say, we received a copy of the contract on Sunday and started going through it only to find out last night we got a new contract and they're not the same. So we've got some problems there. I assume the one we got last night at five o'clock is the correct one, minus the mistake or something that he'd mentioned this morning with regards to Section VIII in the referendum clause. In the contract we received last night, which originally that section was under 22, it was not in 22 so we assume that the referendum aspect had been withdrawn and we started to change our testimony accordingly, only to find out this morning that it was back in again, only it is now going to be under Section VII. So, all I'm saying that if this is a contract, we want to be able to respond to it. If that is the contract.

Lyon: Error due to mag-card...(unclear)

Hartig: I am not going on anything, I am just want an

opportunity to speak to it.

LeResche: Any more questions? Thank you very much.

Wetzel: I beg your pardon, I'm sorry. Mis-communication here. I do have a couple of comments I would like to make, if I may. With respect to our output. I just would like to ... with respect to our proposal.

The first thing I would like to, just to refresh the Board's memory, if I may. I would like to refer back to Bud Gertz's letter of July 28th, 1977, which is so back in the archives you probably don't recall it, but I think it's important from our case that you consider this. In that letter Bud said, first of all, it should be understood that our primary objective has been to propose the optimum installation for the State of Alaska in terms of basic commercial feasibility and ultimate internal benefits in the form of employment and taxes. Based on our long experience in the industry we believe that we have a very good appreciation of the technical, financial and operating aspects of a project of this magnitude. It is our judgment that the project should ultimately take the form of a consortium effort, consisting of chemical companies, oil refiners and marketers, Alaskan investors and others. We are familiar with the necessary factors for successful implementation of such a project, and the type of companies that should take part, a part of the consortium. Given the approval and support of the State of Alaska AOC could proceed simultaneously with the further technical and economic studies for a comprehensive project, feasibility report and take the lead in the formation of consortium of companies having the collective capability of implementation.

We think we've moved a long way down that road, but I think the most important thing is, that the people you heard speaking today, Joe Moore, all have said that the basic plan is sound. We have been consistent in the very beginning as to what is needed. We need a petrochemical refinery in Alaska and it should be a core petrochemical refinery. And I would like to again to show our clairvoyance reference this report and on the very first page we say we should establish a core petrochemical facility; and it seems to me I have heard those words a few times presently today. We felt that then, and we feel it now, we feel we have been consistent in our approach on this.

We'd just like to mention a few other small points we have always stated. As I just read to you that joint ventures would be required from all takers. They've also said the projects slate was not set. Joe Moore said this was comparable. I believe he said the business plans for all intents and purposes were identical at the present time.

(Unclear)

We've been consistent in the business plan. Now, I'd like to speak if I may. And, Mr. Lyon, if you would bear with me a moment, I think the-- I have no differences, basic differences with Peter, Gordon or Joe on what they have said. But I think my, I have to use the old expression, have the emphasis on a different syl·la·ble. I agree wholeheartedly with basic demacro (?) economics that are talked about by these gentlemen, including the Japanese market; however, I think there are some significant differences that should be pointed out. I am well aware. I was in Japan immediately preceding the last trip, and I should

like to point out to you that we went to Japan after we left here on August the 1st and had conversations with all of the chemical companies on this matter and drew our own conclusions to reinforce what we had said in the brown book, about the West Coast being the primary market. But, the point is not that, in fact that we there first and our conclusions have been borne out by the events in the interim. The important thing is that the Japanese, in our opinion and from our discussions as recent -- as recently as the end of last month, are: one, the comfort letters that Alpetco has gotten are comfort letters. They're put out by people who as Joe -- as Peter has explained. This is a country that imports raw materials, manufactures and exports it. It's not only that they import energy or petroleum and manufacturers petrochemical and export them. They are major exporter of steel, steel producers, engineering technology, etc. These companies, these self-same companies, we deal with them all of the time; we have a lot of business dealings in Japan, are interested in any place in the world that might build something and buy something from them that they make; and they make very high quality material. Alaska would be a very logical market, as it was on the pipe for Alyeska, to move large quantities of Japanese goods. And I think, with all due respects to my compatriots, that we ought to recognize that the desire for petrochemicals and I have some of the same comfort letters in my files that they have... are for basic petrochemicals such as ethylene, that might be transported by ship from Alaska or somewhere else. I think its not the finished products that they want. That doesn't do them any good. They are a manufacturing country. If they had oil they would start from the raw materials. They don't. They

start as close up the chain as they can get and get the maximum benefit of the upgraded.

I think that we have properly assessed the probability, using the Prudhoe Bay oil, and we do have a short window on Prudhoe Bay oil. It is going to fall off. If we have 25 years or 22 years or 27 years of supply we've got a lot more time; we can stretch our proposal out. That's why we're prepared to sign that kind of contract. It's a different ball game. We think we've properly assessed the proposal. The problem if, we're looking only at Prudhoe Bay, a more modest venture done in a workmanlike way over the next 18 months, with the State retaining the right to cancel at that time. Now if that's not acceptable, we would be delighted to get our hands on 27 years' supply of 150,000 barrels a day of oil.

Hartig: One more point, Mr. Commissioner, if I may. We mentioned that we would be willing to sign that contract that was recommended to the Board. But we are concerned more with the fact that we were talking about Prudhoe Bay oil and then we question, too, the legality of the future oils that have not even been discovered. Like recognizing in the law it talks about oil which is surplus to the needs of the State of Alaska, and then looking at the definition of the surplus which talks in terms of oil already found and producible. And, here, in this situation, we're talking about commitments of future oils, to a contract, which hasn't even been discovered yet. I think -- I just ask that you have your legal beagles look at that, 'cause I think there're some serious problems with it.

Triplehorn: If I may I'd like to make a comment about the

referendum. Because I think as much as anyone I've been concerned for over a year -- partly out of naivety and ignorance about politics because it occurred to many people, that because regardless of what our policies are, regardless of what is in the contract about no subsidy, there is nothing to prevent in a democratic society ten years from now or fifteen years from now someone coming back and find political pressures to get a contract change. And in recognition of that I'm concerned about it, and I finally came to the conclusion that there was nothing that we could do beyond recognize the possibility of this. In fact, I don't know where the referendum idea came from but I like it. It does provide some standard of protection against what I thought was -- in my pessimistic moments I wondered if there weren't people out there that would agree to anything. With the hope that they might get bailed out by the political (unclear) later on. (unclear) I like it.

Hartig: May I respond that. There's two ways of looking at that. And I can speak from experience having been employed in the Attorney General's office and seeing these exact happen. And unfortunately, and it takes a slap at Alpetco,. I've seen the same thing. We feel that under the basis of their grandeur plan, it is going to have some serious problems.

One, I mentioned the legality. First of all whether you can even commit future oil. But, as an example, when I was still employed with the Attorney General's office we saw this thing happen. People would come in, with not having really spent the time and effort that it took to analyze the problem to find out if you could in fact do something, and I am speaking specifically of the hospital complex in Anchorage.

In the contracts that the State entered into with them there was a development aspect of the thing in which there was just certain development as it went along. And these were contracts that were bid competitively, which we don't have here. We talk about competitive bidding, but we don't have it, because we didn't have the same thing. Assuming that that were true, then we turn around and months later after they built the complexes that are the money makers were reluctant to build the others 'cause they're the losers. Let me tell you, it's exactly what you say. They'll come back and politically... what are you going to say, and refuse them 'cause if you're involved and now, in this situation, you're involved, your royalty oil's involved, you're talking about Alaskans, Alaskan jobs and the corporations and so forth. You're just not going to do it.

Now I think it's a weasley way out though, to give a referendum to the people, if you're elected to serve the people. I think you ought to cut the mustard and do it. But if you want to do it that way, that's fine. That's the reason we say give us the same opportunity, 'cause we'll probably be with you in 18 months, as they will, asking for a subsidy and you're going to be pretty hard pressed not to grant it. That's the sad part of it. That's one reason I said first take a look at our original proposal which is realistically -- can be done -- and secondly consider our offer to sign the same contract, on the same conditions, at the same level as Alpetco's. But you're right.

LeResche: Any questions?

Hartig: Thank you.

LeResche: How many people from the general public, unassociated

with these firms, that are here and would like to speak. You can do it now, or in the morning. The Board would prefer in the morning but if you're here now and would like to talk we'd be glad to hear from you. Unassociated with these firms. I see the Mayor of the City of Kenai here. Would you like to say something Vince?

O'Rielly: Yes, if I may take the time as I have to catch a 5:30 p.m. plane. Following that last presentation I don't know whether I should go back to the Kenai Assembly and say we're not going to get one we're going to get two refineries at this point. But, if I could... before giving the full endorsement, the Assembly of Kenai Borough and Councils of City have chosen to wait until final proposals have been detailed; and the State Board has acted. Nevertheless, you have received indications of support from the Assembly and from the Council and from the Chambers of Commerce. So therefore, the comments I wish to make to you are my own as Mayor of the City of Kenai.

I have had the opportunity of serving the Board through this in Valdez and Anchorage and in Juneau, and I believe the Board has established a contract that's fully protective of the peoples' interest. Namely, no subsidy and secondly, a commitment of proposers proportionate to the State commitment. You have included, as far as I see all the reasonable clauses that prudent government acting as trustee can require.

Speaking of the Kenai area site, I would point out to the Board we have twelve thousand population in the economic area, at this point. We've had a long experience with petroleum. We know, we're receptive and prepared to work with this facility. We are not blue-eyed

children.

Before speaking specifically of the Alpetco proposal, I really would like to address all the other proposals. I really sincerley hope you do not feel it's all in vain and that there are any losers. I know much new knowledge was gained by us and by you. There are and will be other opportunities which include the ample opportunity to merge with the Alpetco venture if that group is approved. But to those people we do say we need your professionalism in this State and I hope to see it in the future.

Now, speaking of the Alpetco proposal. All the members of their group, and particularly their principals, have indicated and demonstrated a willingness to work with the local area on situations of mutual interest. We'll protect and guard our interests and we'll protect ours and promote yours. We will be operating in an atmosphere of respect and friendship. I most sincerely urge at this time a vote by the Board and favor Alpetco. I further urge, under agreed conditions, the location of the facility in the Kenai area.

In closing may I compliment the Board for their thoroughness and diligence. And, about Alpetco - I think we're finally getting to you. I can't help but notice today that some are wearing brown shoes with grey pants and grey suits. So I also urge the proposer to throw on your Kenai clothes and come on down and go to work. Thank you very much. (Applause)

LeResche: I'd like to clarify one thing. Apparently I said yesterday, or some heard me say yesterday, that I had signed the Alpetco

contract. I've not physically signed the contract. I've committed to sign it as soon as all of our attorneys read it again, the Board reads it, and we've made this stylistic and any changes that need to be made. With that - the motion to adjourn.

Lyon: So move.

Triplehorn: Second.

LeResche: In favor? The meeting is adjourned until tomorrow.



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:

Mike Colletta
Pat Rodey
Bill Sumner
John Sackett
Kay Poland

Representatives:

Chairman Bill Miles
Chat Chatterton
Joe McKinnon
Charlie Parr
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

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 than 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

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

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

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

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

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

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

CHAIRMAN MILES:

Isn't that a Catch-22 though Commissioner?

COMMISSIONER LERESCHE:

No.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

I don't follow that, Bill?

CHAIRMAN MILES:

Well I don't either.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Go ahead, we'll get back to that.

COMMISSIONER LERESCHE:

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

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

contract relies entirely on private sector initiatives and mechanisms to put the facility together and to operate it. I think this is important. It does not make the mistakes that the come by chance refinery in eastern Canada made of getting the government involved financially in it. . But it creates incentives for private enterprise to put it together, that's how we wanted it. It seems to be only prudent for the legislature to confirm this sale as a solid epitome of the purposes of the entire concept of why the state retains a royalty interest as a lever for achieving more than can be achieved just with the money we would get by selling the oil at the wellhead. Prudhoe is being produced. An opportunity like this is not going to knock again in the very near future. And I, of course, recommend very strongly that we take this opportunity now. 1e 1-

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 threshold in there but simply commitment to local training and then there are allegations that that commitment isn't being lived up to, it becomes very difficult to determine whether a breach of the contract has occurred or not. And it was my recommendation that from the point of view of a lawyer or somebody looking at it in terms of the legal construct, some minimum would at least give you a threshold test and it was intended to be just that, a minimum -- not a maximum, a threshold test with respect to whether or not they were making an effort or not. If we left out the last part of the term which refers to dollar amounts, it would be much more difficult to determine whether or not a real commitment was made. Now I understand what you're saying about the amount of money. I would point out two things in that regard. First of all this money refers to training specific to the project. The million dollars for the Seward Skill Center, some of that may refer to training that would be adequate for this project and some of it may not so that this is not necessarily -- this million dollar commitment cannot fully be covered by actions of the legislature with respect to its overall commitment.

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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).

COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

No.

SENATOR COLLETTA:

2.4 is inclusive of all state interests in production?

COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

Thank you.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yes.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

No.

CHAIRMAN MILES:

Why not?

COMMISSIONER LERESCHE:

Didn't feel any need to.

CHAIRMAN MILES:

Did you review royalty oil contracts from other states?

COMMISSIONER LERESCHE:

I assume that the attorneys did.

CHAIRMAN MILES

Which ones?

MR. BONESS:

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

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

This is above the weighted average price.

CHAIRMAN MILES:

How much?

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Well, okay.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

But he can't put a price on it?

COMMISSIONER LERESCHE:

No, because it's a probability judgment.

CHAIRMAN MILES:

What do you want to follow on that?

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

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

MR. CHATTERTON:

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

CHAIRMAN MILES:

Go ahead.

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

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

COMMISSIONER LERESCHE:

That's correct.

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

No. Okay.

MR. PARR:

No question about it.

COMMISSIONER LERESCHE:

Okay, I guess I understand that.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yeah, they approved the contract.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

They made five or six specific findings.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

No other oil?

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

We have written approval of the Board.

CHAIRMAN MILES:

Is that right?

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

They speak to this contract.

CHAIRMAN MILES:

Which one?

COMMISSIONER LERESCHE:

This one.

CHAIRMAN MILES:

Which resolution?

COMMISSIONER LERESCHE:

All of them.

CHAIRMAN MILES

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

COMMISSIONER LERESCHE:

Okay.

CHAIRMAN MILES:

We've got a legal opinion that says that.

MR. BONESS:

We haven't had the benefit of that opinion.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Yeah. I just got it yesterday, myself.

CHAIRMAN MILES:

Joe.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

Using royalty oil, yes.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

Not a veto, a chance to meet the price.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

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

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

That's right.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

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

COMMISSIONER LERESCHE:

Yeah.

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

Thank you.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

So ALPETCO gets 150,000 barrels?

COMMISSIONER LERESCHE:

If we have it.

CHAIRMAN MILES:

Yeah.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

Right. Okay.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Metaphysical.

CHAIRMAN MILES:

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

the fox right in the chicken coop.

SENATOR SUMNER:

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

CHAIRMAN MILES:

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

SENATOR SUMNER:

But this wouldn't do it here?

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

(Indisc.)

MR. CHATTERTON:

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

UNIDENTIFIED SPEAKER:

Right.

MR. CHATTERTON:

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

MR. BONESS:

May I interrupt just for a second?

MR. CHATTERTON:

Yes.

MR. BONESS:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

MR. CHATTERTON

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

MR. BONESS:

Okay.

MR. CHATTERTON:

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

MR. BONESS:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

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

MR. CHATTERTON:

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

MR. BONESS:

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

MR. CHATTERTON:

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

MR. BONESS:

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

MR. CHATTERTON:

Well let me interrupt, if I may --

MR. BONESS:

Okay.

MR. CHATTERTON:

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

MR. BONESS:

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

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

MR. CHATTERTON:

We have some unknowns then?

MR. BONESS:

That's right. There are some unknowns.

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

MR. CHATTERTON:

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

UNIDENTIFIED SPEAKER:

He confused me.

COMMISSIONER LERESCHE:

He left out 2/3's of it.

CHAIRMAN MILES:

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

(Off Record)

(On Record)

CHAIRMAN MILES:

Questions.

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

MR. HONIG:

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

CHAIRMAN MILES:

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

MR. HONIG:

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

CHAIRMAN MILES:

Might we get a copy of those expenditures?

MR. HONIG:

Yes, I'm sure.

COMMISSIONER LERESCHE:

They just want to write off Henry. (Laughter)

MR. HONIG:

We've already done that.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

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

SENATOR SUMNER:

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

CHAIRMAN MILES:

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

MR. BONESS:

Okay, thank you very much Mr. Chairman.

COMMISSIONER LERESCHE:

Thank you, Mr. Chairman.

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



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TRANSCRIPT OF TESTIMONY OF

MILTON LIPTON

March 15, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:

Chairman Mike Colletta
Pat Rodey
Bill Sumner
John Sackett
Kay Poland

Representatives:

Chairman Bill Miles
Chat Chatterton
Joe McKinnon
Charlie Parr
Al Osterback

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

back.

MR. LIPTON:

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

You just come on up.

MR. LIPTON:

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

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

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

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

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

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

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

petro-chemical capacity in the Middle East itself.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

MR. CHATTERTON:

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

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

MR. LIPTON:

There is a risk. There surely is a risk.

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. PARR:

Okay.

MR. LIPTON:

That's it.

MR. PARR:

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

MR. LIPTON:

For a specific market. For a specific market.

MR. PARR:

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

MR. LIPTON:

Increasingly, yes.

MR. PARR:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

Absolutely.

CHAIRMAN MILES:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

MR. LIPTON:

For what? I'm sorry.

MR. OSTERBACK:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

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

MR. LIPTON:

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

MR. OSTERBACK:

Thank you, Mr. Chairman.

SENATOR HACKNEY:

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

MR. LIPTON:

With a certain amount of confidence, I will answer, the sky will not fall. Now that I answer the other part of your question, I have more difficulty. But, really, what is now being proposed? The sense of urgency is because of the availability of the oil. If you don't commit it, then whoever wants to put together a project has more and more difficulty of telling his 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 uncertainties against the other. There are risks in this; there are uncertainties if you say no. At least what you've got here is certainly a promise of sincere and major effort. I think that that's about the best that I could. . . There are uncertainties all over the place for them, for the State of Alaska.

CHAIRMAN MILES:

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

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

MR. LIPTON:

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

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

MR. CHATTERTON:

Thank you, Mr. Chairman.

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

Of course, of course. Surely, surely.

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

MR. MCKINNON:

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

MR. LIPTON:

Yes.

MR. MCKINNON:

Another (indisc.)

MR. LIPTON:

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

MR. MCKINNON:

Is that only for a deficiency out of Prudhoe?

MR. LIPTON:

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

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

MR. MCKINNON:

Yes, that's the way I interpret it.

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

I don't believe it does.