

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672

1084 SCOMM 28: JOINT GAS PIPELINE COMMITTEE, 1981-82

MR. MCKINNON:

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

MR. LIPTON:

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

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

MR. MCKINNON:

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

MR. LIPTON:

Yes.

CHAIRMAN MILES:

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

MR. LIPTON:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

They tended to be, yes. Very definitely.

MR. PARR:

Everybody has seen the possibility all at once?

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

Well, maybe commercial decisions and government-political decisions?

MR. PARR:

Possibly.

Thank you, Mr. Chairman.

MR. LIPTON:

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

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

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

CHAIRMAN MILES:

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

profile point that you made.

MR. LIPTON:

On the petrochemical investment there?

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

I'm sorry, I misunderstood you.

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

CHAIRMAN MILES:

Thank you.

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

SENATOR HACKNEY:

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

MR. LIPTON:

Remember what I said?

SENATOR HACKNEY:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

Yes. Sure.

MR. CHATTERTON:

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

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

MR. LIPTON:

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

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

MR. CHATERTON:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

CHAIRMAN MILES:

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

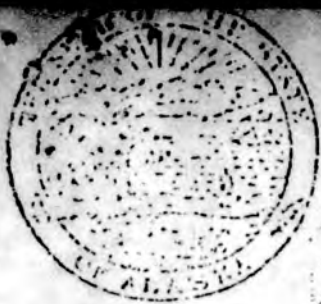
MR. LIPTON:

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

CHAIRMAN MILES:

Thank you very much.

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



Alaska State Legislature

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TRANSCRIPT OF TESTIMONY OF

DR. ARLON TUSSING

March 16, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

Senators:

Chairman Mike Colletta
Pat Rodey
Bill Sumner
John Sackett
Kay Poland

Representatives:

Chairman Bill Miles
Chat Chatterton
Joe McKinnon
Charlie Parr
Al Osterback

DR. TUSSING:

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

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

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

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

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

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

CHAIRMAN MILES:

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

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

DR. TUSSING:

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

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

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

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

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

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

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

into this?

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

DR. TUSSING:

Because there's a surplus of oil.

CHAIRMAN MILES:

Simply because of this?

DR. TUSSING:

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

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

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman.

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

DR. TUSSING:

Yes. Surely.

MR. CHATTERTON:

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

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

DR. TUSSING:

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

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

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

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

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

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

MR. GRUENING:

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

DR. TUSSING:

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

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

MR. GRUENING:

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

DR. TUSSING:

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

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

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

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

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

UNIDENTIFIED SPEAKER:

You've been there before.

DR. TUSSING:

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

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

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

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

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

UNIDENTIFIED SPEAKER:

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

DR. TUSSING:

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

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

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

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

UNIDENTIFIED SPEAKER:

I think we should just keep going.

DR. TUSSING:

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

UNIDENTIFIED SPEAKER:

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

DR. TUSSING:

Yes.

(FIVE-MINUTE BREAK)

DR. TUSSING:

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

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

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

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

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

CHAIRMAN MILES:

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

DR. TUSSING:

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

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

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

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

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

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

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

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

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

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

MR. PARR:

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

DR. TUSSING:

Yes....

MR. PARR:

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

DR. TUSSING:

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

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

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

MR. PARR:

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

DR. TUSSING:

Well, that's the most likely.

MR. PARR:

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

DR. TUSSING:

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

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

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

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

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

CHAIRMAN MILES:

Anyone want to comment on that?

DR. TUSSING:

Well, maybe that's unfair....

CHAIRMAN MILES:

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

DR. TUSSING:

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

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

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

DR. TUSSING.

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

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

CHAIRMAN MILES:

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

DR. TUSSING:

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

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

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

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

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

MR. PARR:

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

DR. TUSSING:

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

MR. PARR:

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

DR. TUSSING:

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

it gets only the in-value price.

MR. PARR:

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

DR. TUSSING:

Well....

MR. PARR:

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

DR. TUSSING:

Well, demand is not outstripping supply now.

MR. PARR:

This year, this year.

DR. TUSSING:

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

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

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

/Whereupon the tape recorder apparently ran out of tape/

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

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

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

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

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

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

CHAIRMAN MILES:

Are there any questions for Dr. Tussing?

Thank you very much. It was exciting and enlightening.



Alaska State Legislature

POUCH V, STATE CAPIT
JUNEAU, ALASKA 99
907 465-3800

TRANSCRIPT OF TESTIMONY OF

ALPETCO ATTORNEYS

March 20, 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
Charley Parr
Chat Chatterton
Joe McKinnon
Al Osterback

(First Portion of Tape Indiscernible Due to Poor Quality of Tape)

MR. ROGERS:

I believe that's the main management. If you have any questions about any of the individuals I'll try to answer them for you. I think they have various responsibilities. I will have an annual report sent to you.

CHAIRMAN MILES

Okay, I would appreciate that.

CHAIRMAN MILES:

Mr. Rogers can you tell me in the contract where it says that ALPETCO has to process 150,000 barrels a day?

MR. ROGERS:

No, there's no requirement that we have to process 150,000 barrels a day. There is a requirement that we -- the feeling there was that because of the lack of knowledge about the configuration of the plans and because of the concern that once we got the plant in operation we would have what is now planned to be a two and half billion motivation to keep the plant operating, we have no economic interest in expending two and a half billion dollars to have 150,000 barrels a day coming at us. We are concerned that we might want, for reasons of our own, to shut portions of the facility down to add on facilities to shut down to realign the facilities or something like that. We did not want to have a 20 year period of time in which we had an obligation to keep the (indisc.) running. I think Commissioner LeResche was satisfied that if we did sink

all of the dollars in a minimum of a billion five, that we would have plenty of reason to continue the operation of the facility. Our lenders would certainly not lend us the money, except on the basis of the continued operation of the facility.

CHAIRMAN MILES:

Aside from the 30,000 barrels a day (indisc.), is there a requirement to process anything else in the contractual -- in this contract?

MR. ROGERS:

I think it's implied that if we build a petrochemical facility and put a billion and a half dollars in it, it has got to process something and the current configuration on that is to process 60 to 90,000 barrels of crude oil and fuel oils per day. Only a part of it can go into petrochemicals and the rest for in-state fuels. So to answer your question directly, no there is no requirement -- the requirement that we process a certain amount of barrels. There's only a requirement that we continue the operation, but if we follow the criteria of 10.1, excuse me, 10.2, and meet those criteria -- those are the bench marks, so called bench marks -- if we meet the general requirements to construct the facility which is Article 4, the two of those together should satisfy. I think you just have to assume that economic common sense will prevail. A lot of comfort was received by Commissioner LeResche in knowing that if we got a billion and a half financing commitment and if we got 70% take or pay contracts, the rest would all follow and to require a certain minimum production of us, require continued operation, was really an unnecessary thing to do once we passed the point of no return so to speak.

CHAIRMAN MILES:

Representative McKinnon.

MR. MCKINNON:

On those same lines, if it turns out that you only -- for some reason or another -- you take 120,000 barrels a day, is the State obligated to supply an additional 30,000 barrels a day? (Indisc.-- simultaneous speech)

MR. ROGERS:

Yes, literally under the contract there is and the principle reason for that is that there may be a period of time in which there is a -- for instance a shutdown of the line. It was suggested during the negotiations that the production delivered be limited to that which paralleled the amount of processing going on in the facility. But we asked that that not be imposed because we are planning a 30 day storage at the site and there will be an amount of storage in great big quotes, in transit so that if the pipeline froze or shut down for an extended period of time, we would have enough storage and enough in process of delivery from Valdez to wherever we're going -- could be even at Valdez, that we would be able to survive

for that 30 day period. Once everything was turned back on, we would want to (indisc.) as much as we possibly could not only to feed the refinery but to replenish that backlog of the feed stock storage. So we couldn't really tie the production to the -- the deliveries to the production.

MR. MCKINNON:

If it did turn out that (indisc.) level of use was 120,000 barrels a day, would the State still be obligated to provide the additional 30,000 barrels per day if ALPETCO, for instance, wanted to take the oil for whatever other purposes they had for it (indisc. -- simultaneous speech)

MR. ROGERS:

Under the pricing formula I think there's no reason why we would. We frankly are having serious concerns whether we'll ever take interim delivery before the petrochemical facility is operating. The pricing under the contract is never going to be below market and can and probably will operate to result in an aggregate price in excess of market and we were told that the brokerage of oil allows for such a narrow margin that there would be no future in (indisc. -- cough). We're in the business of trying to build this petrochemical refinery and it's a very different business that we're going in. I don't think there's much motivation to go into spot sales of 30,000 barrels a day. I think under the contract it's possible. *?? impossible.*

MR. PRATT:

There's one other -- Mr. Chairman, may I comment?

CHAIRMAN MILES:

Mr. Pratt.

MR. PRATT:

There's one other answer to your question -- it would be no, you don't have 150,000 barrels a day, we wouldn't get any more than 120 if that's all you had.

MR. ROGERS:

Well that's all we had --

MR. PRATT:

-- (indisc. -- simultaneous speech) the answer you were looking for originally but that's another facet of the answer.

MR. ROGERS:

Well we had 120,000 barrels.

MR. PRATT:

(Indisc.)

MR. ROGERS:

Even if we had other sources or other --

MR. PRATT:

If you only had 120,000 in royalty oil, that's all we get. Am I not correct in that?

MR. ROGERS:

I think technically under the contract we have the right regardless of the present need of the refinery, we have the right to call for up to 150,000 barrels.

MR. PRATT:

But I'm saying if there were only 120,000 (indisc. -- simultaneous speech)

MR. ROGERS:

Yeah, I see, what Henry is saying is that under present circumstances the proposed favored customer clause will never come into effect if the State does not decide to sell any oil cheaper than they're selling to us. 2.4 will not come into operation if there's no in-kind oil available at (indisc.) and if only 120 is coming out at the end of the line, that's all we'll get and to that extent that's correct. And that we're going to have to live with. I'm not answering your question, am I?

MR. McKINNON:

No, you haven't. (Indisc.)

MR. ROGERS:

(Indisc. -- simultaneous speech) We've always heard of that as present design is 150,000 barrels per day. The possibilities of it being scaled down are off in the future and I really can't assist (indisc.-- cough) talking about it presently. If it is scaled down, it results in a change in a section under the contract and a change of intent on our part and literally under the contract we could have 120,000 barrels a day refining capacity and still require 150,000. But in negotiations it was not required because

everybody felt that there would be no economic motivation on our part to call for that extra 30 unless we needed it for extra storage or something like that.

CHAIRMAN MILES:

Representative Osterback.

MR. OSTERBACK:

Thank you Mr. Chairman. What else would you be -- the question asked there today on your petrochemical plant, you also get material for making nylon rope (indisc.), would there be any chance -- would you be interested in that or would that have to be a separate contract or do you plan on adding to your plant?

MR. ROGERS:

Again, I'm just repeating things that I've heard from my clients. I think the contracts I've written mention in products of that nature that our facility as such is not going to produce end products like that but we're hopeful that we can arrange the purchaser base in a manner that the purchaser might be interested in buying the products out of our facility and next door build an end product use factory. But I do not believe we're going to be doing end product, particularly final finished products, we're (indisc.) building blocks.

MR. OSTERBACK:

But there would be material available for it?

MR. ROGERS:

Yes, hopefully that's what will help -- will further industry in the area and location of the facility.

MR. OSTERBACK:

Well I don't know if anyone's familiar with it here but when you're talking about the bottom fish now -- the nylon rope and polyethylene, the plastic bags which you use on crab buoys -- we're buying them from Norway now at about \$50.00 apiece, a 15" bag. By the time you pay \$10.75 a pound for gillnet (indisc.) and nylon rope is about the same, you take a big (indisc.) line or crab buoy line, it literally runs into thousands and thousands of dollars just for one boat.

MR. ROGERS:

Mr. Spitz at Chem Systems, I think, was in the ALPETCO story, you can see the different demands for the feed stocks and I think that that economic problem exists all along the West Coast.

MR. OSTERBACK:

Yes, we're importing most of our stuff. And if the State could go into a deal like this, if (indisc.) follow up on, I think (indisc.) on this contract right here.

MR. ROGERS:

And reduce the consumer's prices. If the volume -- the only thing that might limit it is the potential volume. If the volume is there, it becomes economical, surely someone will come in and do something of that nature.

MR. OSTERBACK:

I imagine the volume (indisc.) now. I don't know how much it would take to (indisc.)

MR. ROGERS:

(Indisc.)

MR. OSTERBACK:

And the price -- you just take nylon -- oh from something like \$3.00 a pound to \$10.75 in the last three years. You don't know where it's going to stop. (Indisc.) for a drift gillnet (Indisc.) a hundred pounds. And about \$360.00 three years ago and now it costs us over a \$1000 dollars.

MR. ROGERS:

All your nets are made out of petrochemical products.

MR. OSTERBACK:

Right, nylon and ---

MR. ROGERS:

You'd think there'd be a huge market for that.

MR. OSTERBACK:

Now your rope, there's no more manila rope or (indisc.) rope made any more, it's all nylon or polypropylene and (indisc.) as far as I know and I don't know much about it. But I know if we get into the bottom fish industry, there's a big demand for that type of thing. Because all of that is synthetic and everything.

MR. ROGERS:

Um humh.

MR. OSTERBACK:

Even your cable is (indisc.).

MR. ROGERS:

(Indisc.)

MR. OSTERBACK:

So much steel and so much polypropylene to make it kind of flexible. So that's what I wanted to know if you guys ever thought of anything like that.

MR. ROGERS:

Well we have thought of it in the context of letting further industry develop, that maybe it's economical for them to do it. It's not part of the present project. We've got our hands full trying to get this facility up.

CHAIRMAN MILES:

Mr. Rogers, under the clause, you know at ALPETCO we asked them if they would take lower priced oil at the same terms and conditions. If the legislature would approve the contract before it, would it thereby be foregoing any options in future contracts -- should you exercise an option to take other (indisc.) in your legal opinion, translated into labor (indisc.)

MR. ROGERS:

First of all, (indisc.) facility as an operation, you can sell your oil -- you can give the oil away until that's the case. The concern stems from us putting in a 2.5 million dollar facility and then the state selling a significant quantity of oil to people it's not presently dealing with. The Tesoro contract is excluded and of course the North Pole is excluded and selling that oil at a subsidy price at a later date in a manner that would destroy our competitive market. We're making a promise that we will build a facility and that we'll service in-state needs and we feel that this will do a lot of good things for the State of Alaska and the (indisc.) for that is just to ask you that if you do decide to sell oil, you're going to sell it all day long at the same (indisc.) price you're selling it to us at. The one area in which that is not true is that the price formula under Article 2.3 is a formula price that figures in not only what you're selling your oil for but the computed transportation costs. In simple terms it means that if there is a sale of Cook Inlet oil at an in-value price, we will probably under 2.3 be able to purchase that oil because it will be at a lower gate price. Fred Boness refers to it as a gate price which is a good term. All 2.3 says is that if the price at the gate of Prudhoe oil is higher than the gate price of the oil from Cook Inlet or wherever, then we have the right of first refusal basically. We have the right to take that oil in place of the Prudhoe oil we're buying and that will allow us the competitive ability to continue operations of our facility.

CHAIRMAN MILES:

What I'm asking is, by approving this contract, let's say you exercise that option that you just laid out (indisc. -- airplane)

the terms and conditions as it was offered by the state. Does the legislature still have the power to say yea or nay as it does right now on oil and gas sales or would we be getting supplied --

MR. ROGERS:

Yes, it certainly would.

CHAIRMAN MILES:

We would still be able to say --

MR. ROGERS:

You would still have the decision to sell or not sell. All we're saying here is that if you decide to sell, if you did decide to sell, and you decide to sell at a lower adjusted price, then we get the right of first refusal. You're talking about 2.3, aren't you? This is the most favored customer clause. We are not interfering with the legislature's right to approve any contracts, it's just a matter for your concern as to who the purchaser is.

CHAIRMAN MILES:

What would happen if in that case you took oil or determined it was wrong to take oil under another set of facts and the legislature said no?

MR. ROGERS:

Then we would stay where we are. The party at that point in time would be that we would still be drawing oil down under the Prudhoe agreement. There's a six month notification procedure under the Prudhoe agreement and there are some notice requirements -- I'm not familiar with in all of your leases and so nothing would ever happen until the legislature approved or disapproved. If it disapproved then we'd all just be left where we were in the beginning.

CHAIRMAN MILES:

I see. It wouldn't be a court battle that ties up any sale or anything.

MR. ROGERS:

No, sir. We have no right to the oil unless a decision is made to sell it. I don't see on what grounds we could file any suit. We have no -- the legislature's authority is pretty clear. We just want to be the purchaser. We do not want to interfere with any of the procedural aspects of the sale, particularly the legislature's authority to say yea or nay.

CHAIRMAN MILES:

So you don't envision any court fight over it. Did you want to comment on that Elke?

MS. KALLAB:

Just very quickly. When you say not to destroy the competitive

price, you know, that's provision 2.3. Of course it is possible to have a competitor bid an in-value price, (indisc.-cough) lower transportation costs, you might wind up with a lower price and thereby you become entitled under 2.3. Conversely then, of course, in order for anybody else to purchase that oil, they would have to give a premium to the state, is that correct?

MR. ROGERS:

Yes, all of this assumes a totally imperfect (indisc.) market. If everything's working right there will never ever be any difference, but we know that doesn't always prevent ... The answer to your question is yes. (Indisc. -- loud traffic noise)

MS. KALLAB:

(Indisc.-- loud noise) and to, you know, be fair, you would conceivably ask somebody else to give premiums so that you can continue to pay for in-value.

MR. ROGERS:

If the state was smart they'd sit there and figure out the gate price as one way, and the other way and they'd say okay, we're going to offer this for a premium of "x" dollars and ALPETCO in an exercise of it's economic judgment would say well we'd rather have that oil and it would be one of the rare instances in which the state would be able to get a premium and everybody would walk away happy.

CHAIRMAN MILES:

Representative McKinnon.

MR. McKINNON:

The uppermost question you presented -- if ALPETCO exercises its option, a new contract would have to be presented to the legislature. And the legislature would have to -- and the legislature turns it back. Now you're saying there'd be no court cases involved. The state then went on to once again attempt to dispose of the royalty oil. What would the situation be? Would ALPETCO then still have first option which would have to go back to the legislature?

MR. ROGERS:

Yes, sir. As long as that process, a lower adjusted price, continues ... (interrupted)

MR. McKINNON:

Then theoretically the oil could never be sold unless . . .

MR. ROGERS:

Well that's where the philosophical rub comes. The question is does -- will the legislature not want the oil to be sold ALPETCO? Will they not be able to find a purchaser that will pay the same price. We have a right of first refusal. It is going to be difficult to give a subsidy price to another competitor. There are obvious ways to get around it, you can sell the oil at the price and then grant them a monetary subsidy if you get into business development and things of that sort. We are worried more about (indisc. -- cough) subsidy that would be represented by the lower price.

MR. McKINNON:

The contract requires that the royalty oil be offered under the same terms and conditions. Taking a hypothetical -- say the state decides to release Kachemak Bay. There's a discovery and a substantial amount of royalty oil. And that royalty oil was offered on the condition that it be used for a refinery on the Homer Spit. Now would ALPETCO be obligated to accept that royalty oil under those same terms?

MR. ROGERS:

Would ALPETCO have an option?

MR. McKINNON:

Well if they exercised the option, would they be required to build a refinery on the Homer Spit?

MR. ROGERS:

Oh, yes.

MR. McKINNON:

Okay --

MR. ROGERS:

I would think so.

MR. McKINNON:

Under those conditions then ALPETCO just couldn't exercise its option to take the oil --

MR. ROGERS:

To take the oil and leave it, no sir. Not at all.

CHAIRMAN MILES:

Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman. Let's run this over again a little bit for me. The legislature if there is outside -- whatever you want to call it -- royalty oil, state royalty oil from Cook Inlet or any place. If the only time that the legislature would become involved is a determination as to whether to take that royalty oil in-kind or in-value. Now, if the legislature determines to take it in-kind, there would be no legislative approval be necessary for you to exercise, as I conceive it, for you to exercise the option under 2.3. The legislature's not involved other than they don't approve this contract.

MR. ROGERS:

Pardon my ignorance but aren't all oil and gas contracts subject to legislative approval?

MR. CHATTERTON:

This is a contract right here and the terms of 2.4, I guess, yeah 2.4, I'm sorry, if the legislature approves this contract why other than -- the legislature will never be involved again; except in the determination that the yet to be discovered royalty oil in-value or in-kind. We would have no approval -- we are not in any position to say yea or nay to you.

MR. ROGERS:

I'm totally out of my field of practicing here -- Alaska law. But I don't think that there's a sale of oil under 2.3 until the legislature has approved the contract. I don't --

MR. CHATTERTON:

-- approve of this contract.

MR. ROGERS:

No, approve future sales contracts.

MR. CHATTERTON:

Would you show me that? Where the law is?

MR. ROGERS:

The way the law reads, I don't think --

MR. CHATTERTON:

Present law says you (indisc.) the right to approve any contract for the sale of royalty oil. Any contract.

MR. ROGERS:

This is only making up to 150-- this is already in the contract that you have.

MR. CHATTERTON:

I understand that, but when somebody else's contract comes along you have the right to approve their contract. But I can't approve their contract because you've got the oil.

MR. ROGERS:

Alright, let me make --

MR. CHATTERTON:

You don't have to answer it now, but you should look into it. I read this 2.4 --

MR. ROGERS:

Let me make sure -- you're on 2.4, we're on 2.3, maybe that's the reason

MR. CHATTERTON:

Well 2.3 is almost the same thing. We're giving you the right of first refusal in both things on any royalty oil.

MR. ROGERS:

I think on 2.4 you have a valid concern. On 2.3, I don't think -- there's certainly is no intention and I don't think the terms put along side the statutory requirement of legislative approval would permit ALPETCO to buy any oil under 2.3 without further legislative approval.

MR. CHATTERTON:

Alright --

MR. ROGERS:

Under 2.4, I think your concern might be expressed by having the in-kind requirement, we have the ability to prevent sales in the future.

MR. CHATTERTON:

I think we do, but I don't know. But I will yield to you on 2.3 and I'm sorry. You're right on 2.3.

CHAIRMAN MILES:

I think Mr. Berry (ph) had a comment.

MR. BERRY:

Well initially I was having the feeling that you were talking about two different agreements.

MR. CHATTERTON:

I think that's what was happening, I apologize.

MR. BERRY:

I think one way of thinking in 2.4 is that you confuse this contract with having sold 150,000 barrels a day.

MR. CHATTERTON:

(Indisc.)

MR. BERRY:

And insofar as it's necessary to take oil from other leases to make that 150,000 barrels a day that has been sold by this contract and it wouldn't be subject to legislative approval or disapproval.

MR. CHATTERTON:

Correct. And from a completely practical standpoint, we'll always be in this position. I doubt if there's ever more than 150,000 barrels of royalty oil coming from state lands 5 years down the road.

MR. BERRY:

To the extent that that's the case, it has been sold by this contract and it would not end up being before the legislature again.

MR. CHATTERTON:

That's correct. Mr. Chairman.

CHAIRMAN MILES:

Mr. Chatterton.

MR. CHATTERTON:

With your permission, I'd like to (indisc.) Maybe the fastest way for me, rather than asking -- getting around asking questions, is to suggest to you a scenario and have you tell me that this contract won't let me do it. Can we do it that way?

MR. ROGERS:

Sure.

MR. CHATTERTON:

Okay. My scenario is this and this is despite the language set forth in -- oh whatever it is -- 4.2, I believe. Despite the language set forth there, (indisc.) obligations. My scenario is that I believe that if I were ALPETCO and I was so inclined despite my best good intentions to build a world scale petrochemical plant in Alaska which is what the intentions of both parties are. But then I come to the contract and I say well things aren't going so good and so I say that I'm going to make the necessary expenditures to build a 30,000 barrel a day feed stock products refinery, middle of the barrel products, and so forth and so on, typical Alaska market products, jet fuel, and I'm going to get some letters that say that I can honestly, at the drop of a hat, go and borrow 1.5 billion dollars at any time that I want to, just by picking up the phone. And I go a little further --

MR. ROGERS:

(Indisc.)

MR. CHATTERTON:

Yeah. I have my letter to show that I am financable for the world scale petrochemical plant and I got mad at the end of the 18 months term. At the end of 36 months I have a nice little refinery taking 30,000 barrels a day. At the end of 18 months I'm already exchanging or selling, or something, fuel, my 150,000 barrels a day. At the end of 36 months say, or something like that, I'm running 30,000 of it through my refinery and sending the other 120,000 barrels a day on south and making money doing that and I don't plan to go any further than that. Now would you show me that that doggone guy over there called seller can break this contract? Will you show me --

MR. ROGERS:

Yes, I can show you one -- first the assumption in my mind is it's not feasible economically, -- (indisc.--simultaneous speech)

MR. CHATTERTON:

Are you an attorney, or are you a financial --

MR. ROGERS:

I'm an attorney. (Indisc. -- simultaneous speech)

MR. CHATTERTON:

Let's don't argue that point.

MR. ROGERS:

The question has been asked before and the continual response of our

people is that you cannot build a fuel refinery for a billion and a half dollars. A fuels refinery --

MR. CHATTERTON:

I don't have to spend any billion and a half dollars.

MR. ROGERS:

In the contract.

MR. CHATTERTON:

Show me in the contract. I don't want the economics. I want you to show me in the contract that I can't --

MR. ROGERS:

10.2 (9) gets to that point.

MR. CHATTERTON:

It doesn't quite. Unless I can't read the English language. But go through that (indisc.) by seller steps. It's on page 31. I guess that's a good place to start. Keep in mind my scenario. I'm going to have a 30,000 barrel a day products refinery and I'm going to have a letter of credit for 1.5 billion dollars and I'm going to be taking 150,000 barrels a day of oil and I'm going to run 30,000 through the refinery and I'm going to ship 120,000 south. I want you to show me the language in this contract that lets the state cancel it.

MR. ROGERS:

At that point.

MR. CHATTERTON:

At any point that the state realizes that I don't plan to build a world scale petrochemical plant.

MR. ROGERS:

But we still have to (indisc.) ourselves in economic reality.

MR. CHATTERTON:

No we don't. I'm looking for contract language that gives the state an oppor--at what point and under what conditions could the state terminate this contract?

MR. ROGERS:

How much have we spent at that point?

MR. CHATTERTON:

I think we've only spent about 600 million dollars.

MR. ROGERS:

Okay, that's at the 36 months.

MR. CHATTERTON:

At 36 months -- keep in mind that that's not what you have spent, part of that 600 million is what you have spent and the other part is what any political subdivision has spent.

MR. ROGERS:

Right.

MR. CHATTERTON:

It's the sum of the two.

MR. ROGERS:

If you'll make a note, I'll explain how that came into being.

MR. CHATTERTON:

(Indisc.--simultaneous speech)

MR. ROGERS:

To answer your question, the next termination point would be twelve months later, if we had not expended a billion dollars. At that point, by the preparatory language in 10.2, the contract is automatically terminated --no further action of any state official and we're sitting there with a 600 million dollars fuels refinery with no feed stocks.

MR. CHATTERTON:

Okay supposing with my scenario, I got to that point and the state proceeded to terminate. I had my little plant. I'd spent my six hundred million dollars, or my share of the 600 million, and all of this and I didn't plan to go any further and the state comes-- the Commissioner of Natural Resources says on this 48 months "we're canceling your contract". What recourse would I have if I didn't want the contract canceled?

MR. ROGERS:

It's specifically provided that the Commissioner does not have the authority to prevent the termination from occurring. He has certain authority to extend, particularly to allow ALPETCO

to go to the legislature but he can't stop the termination of the contract.

MR. CHATTERTON:

No. So he says "the contract is terminated". Now ALPETCO says "the hell it is, buddy, I'll see you in the courthouse". Is that a fair scenario.

MR. ROGERS:

I don't understand where we're going with the analogy.

MR. CHATTERTON:

I'm saying that the state can't terminate the contract. I'm asking you how can the state terminate the contract.

MR. BERRY:

Show him where it can terminate it.

MR. ROGERS:

It just says that at the beginning of 10.2, this agreement shall terminate upon the failure of buyer to take each one of those. There is no action required on the part of the state. The contract expires. The state stops delivering the oil. You guys have got the oil. All you do is cut it off and (indisc.).

MR. CHATTERTON:

Then you go to the courthouse and sue us for breach of contract.

UNIDENTIFIED SPEAKER:

On what grounds?

MR. ROGERS:

On the grounds of economic loss. There is no right of action in any court of law. I know the Alaska laws are very similar to all the laws of the other states and there can be plenty of injury but unless there's a wrong, there's no (indisc.) And unless the state had done something wrong or has broken its contract, we have no remedy. Furthermore, I hate to go out on extended examples like this when that's playing economic Russian roulette and our lenders are not going to want to see that.

MR. CHATTERTON:

They haven't loaned you anything yet, to speak of.

MR. ROGERS:

600 million dollars for a plant -- (indisc. - simultaneous speech)

MR. CHATTERTON:

(indisc.-simultaneous speech) going to get the plant.

MR. ROGERS:

You've got 600 million dollars in the ground. No one is going -- the contract is long because we have made (indisc.- simultaneous speech)

MR. CHATTERTON:

600 million dollars in the ground and you're making a profit and you don't want to go any further.

MR. ROGERS:

I'm saying that the Russian roulette which your example assumes, would not be a rational business decision. No businessman would risk a 600 million dollar plant with no feed stocks to put in it.

MR. CHATTERTON:

That's my point. I say that you will require if you go to court because of the materiality of breach clause on page 42, that if you will go to court and require the state to continue to deliver, I'd dare say the court is going to support.

MR. ROGERS:

No. The materiality -- the breach in that instance would be on our part and our failure to meet our dollar obligation, the materiality clause accepts all of section 10, if you'll note that, number 1. It's right there in the end of the contract somewhere wasn't it?

MR. CHATTERTON:

It's on page 42 at the bottom of it. My point is very simply that the state is suffering no economic loss --

MR. ROGERS:

I was thinking of the reasonableness of approval.

MR. CHATTERTON:

If the state is suffering no economic loss which it would not be, and under the scenario I gave you it wouldn't have its world scale petrochemical plant, so it would be suffering no economic loss and it would still --

UNIDENTIFIED SPEAKER:

(indisc.) the fine legal line of the contract would still be -- there would be no --

MR. CHATTERTON:

(Indisc. -- simultaneous speech)

MR. ROGERS:

I'm having trouble, frankly, seeing why -- there's a (indisc.) provision at the beginning of 10.2 that says the contract is automatically terminated if you don't spend the next incremental amount of money.

CHAIRMAN MILES:

Mr. Rogers or Mr. Berry.

MR. BERRY:

Could you -- I'm having some difficulty understanding (indisc.) familiar with this type of contract in the construction business but what exactly does commit to expend mean and whether there is any standard for that or any time period to assume to be connected with a commitment to expend a certain sum of money.

MR. ROGERS:

I think the context of the being is a contractual obligatory and enforceable contract which we have entered in an (indisc.) purchase order for that for whatever it is. But many of these components are built over a period of several years and the delivery schedules are not completely within our control and that's what the commitment -- we don't know exactly when we're going to spend it but the binding nature to pay for it is what the commitment is, an obligation to pay for it.

MR. BERRY:

So that it would entail a purchase order or an order for the construction without pinning down in any way the time frame over which the construction would (indisc.).

MR. ROGERS:

Right. The reason we're in all of these dollar things rather than in specifications is that frankly we don't know exactly what the configuration of the plant is and what the time frames will be. Particularly with such a large facility like this, the great variable right now is what the purchaser of the product wants. And we don't know exactly (indisc.) is. There are some

processes presently that no one knows whether they're economical or efficient now if the new union carbide ethylene processes are efficient as everybody says, that a purchaser will want more ethylene because it reduces the cost of producing ethylene by 30%. We could not stipulate that we will have an x or a y or a z by a certain amount of time because we do not indeed know (a) whether that particular type of unit is going in and (b) what point in time during the construction schedule that particular unit will go in. So we found the benchmark in the one common ground and that is spend enough money to be able to insure that something large and something of a petrochemical nature was being built. It's -- under the present thinking, it's impossible to spend a billion and a half dollars and build just a fuels refinery without going way over the assured source of crude oil. As I think I mentioned before a 150,000 barrels per day refinery would cost less than 700 million dollars. A billion and a half has to go somewhere and that's into petrochemicals.

CHAIRMAN MILES:

Representative Chatterton.

MR. CHATTERTON:

Thank you, Mr. Chairman. Just to continue. Ed, you have 14.3 on page 42, I believe, in front of you.

MR. ROGERS:

Let me explain one thing that's rather technical and was a request of ours. We asked that the termination provisions in Article 10.2, the benchmarks were not called a default or contract breach but that the state merely had a right to terminate our agreement and be covered for any loss. We're obligated, for instance, to continue accepting deliveries of oil and things of that sort so conceptually 10.2 is not covered as a default or a breach of contract. It is merely a grant -- the reason why it's in Article 10 rather than in Article 14 is that it grants a right of seller independent of breach or anything else, the right to terminate the contract. If you don't do this then the contract ends. The one safety valve to that or the extension period stipulated in 10.2 that permits us to seek an amendment to the contract or get an extra little time if something has delayed us.

MR. CHATTERTON:

Okay. Then it is distinctly your belief that the contract says if within 72 months, I think another six months probably, extends for 12 months, within 84 months if you have not expended or committed to spend one and a half billion dollars why we can cut the oil off -- that we can cut your oil off?

MR. ROGERS:

Exactly.

MR. CHATTERTON:

You would have no recourse against the State?

MR. ROGERS:

Right. I think also, if we assume your example of -- your example does have credibility in the area of the building. It's my understanding that the fuels portion of the facility will be the first and then the higher processing will be built later. In the event that at any point you feel that we are not committed to a petrochemical facility and probably -- I cannot keep us out of the courts, that's the only way to resolve things if everybody's yelling, but I think you have a good action under 4.2 to say you have violated your obligations to build a petrochemical facility. You're just building a fuels refinery and you can see the termination that way. Our great fear, frankly, is that we're pouring so much money into this thing, we're never going to do anything to even imply a breach because with so much money involved I think we're going to do everything we can to exercise caution.

MR. CHATTERTON:

Of course the definitions section of petrochemical facility refers you to the language in 4.2.1.

MR. ROGERS:

Right.

MR. CHATTERTON:

And, you know, if that really says that you -- it has the word petrochemical manufacturing facility in the fourth line of that paragraph. But it sure as heck doesn't define it, does it? Just read that. "Such facility shall include facilities for the manufacture of energy fuels"; that's my 30,000 barrels "aromatics", yeah, it's going to manufacture those because they're going to come off "olefins", it's going to manufacture those, they're going to come off "and petrochemical derivatives"; that's the whole suite of chemicals, it's going to come off. It's not going to be sold as a product. It's going to be dumped into one of these tanker company's ships and sent down south just like it is on any refinery in the State of Alaska now. It hasn't told me a thing that you're going to make any petrochemicals or some of the derivatives.

MR. ROGERS:

The problem that we wrestle with in trying to define anything further in the contract is that we can't define that until we

know that the producer, the purchaser of the product -- we have been doing this thing chicken and egg for many months now. And a purchaser won't talk to us until we've got a supply and hardly anybody else for that matter, so that we in this paragraph did not want to bind ourselves to any particular configuration.

MR. CHATTERTON:

I agree, you did not.

MR. ROGERS:

We hopefully have, and I think, honestly speaking, that if everybody will keep their copies of our presentational material in which there are described a mammoth, world scale heavily petrochemical refinery, that ALPETCO would look pretty silly in court saying well we complied with them. We had a few olefins and petrochemical derivatives being (indisc.) off this fuels refinery here. The judge is going to say well how about this nice two volume blue brochure you submitted to the state. What is this thing that you submitted here. And I think the description of this has to be rounded out with the context of the facts of the contract. I would not like to be -- I'll join the Alaska side on that.

MR. PRATT:

May I ask a question, Mr. Chairman, strictly from a stupidity point of view?

CHAIRMAN MILES:

They are so used to stupid questions, Mr. Pratt.

MR. PRATT:

Is Tesoro and North Pole presently producing olefins and aromatics?

MR. CHATTERTON:

Sure.

MR. PRATT:

They are.

MR. CHATTERTON:

Well hell yes.

MR. PRATT:

Polypropylene, polyethylene?

MR. ROGERS:

Not the polys, I don't believe. I think --

MR. CHATTERTON:

(Indisc.--simultaneous speech) we're having an unsemantical understanding here. As a saleable item, they are not, no. As a saleable product, they are not. But keep in mind that's what crude oil is. Now all they are removing from crude oil let's say Tesoro or a Chevron refinery or North Pole, all they're removing from the crude oil is what are called middle of the barrel products, the stove oil, diesel oil, jet fuels. Now that's being removed. Now everything else, all the olefins and all the aromatics and everything else are also being removed from the barrel but they are being shipped south.

UNIDENTIFIED SPEAKER:

(Indisc.)

MR. CHATTERTON:

Yeah. They are being shipped not as separate items, but as a addition----

MR. ROGERS:

(Indisc.--simultaneous speech) the production of that is just what comes off naturally, rather than what's produced and its' a very small amount in relationship to the fuels produced.

MR. CHATTERTON:

No, actually it's very large, about two thirds. Each barrel that goes through one of these refineries in Alaska, well about a third of a barrel stays in Alaska as products and two thirds is shipped south.

MR. ROGERS:

In what form?

MR. CHATTERTON:

In liquid form.

MR. ROGERS:

They're not aromatics or olefins?

MR. CHATTERTON:

Yes, there's aromatics and olefins.

MR. PRATT:

Are you saying that they're all mixed up together in one barrel?

MR. CHATTERTON:

They are not in into individual products.

MR. ROGERS:

I think that in the context that this language speaks, we're speaking about the production of separated olefins and separated aromatics. It's not -- I think that's what the parties certainly understood and while it's possible in a fuels refinery to draw off certain small amounts of separated -- I don't think the industry considers anything an olefin or an aromatic until it's separated from its generic tie.

MR. CHATTERTON:

I think you're right. I'm paranoid, I admit it. I can't see the language (indisc.--simultaneous speech).

MR. ROGERS:

As John Barbour used to say, I'm not really paranoid, everybody is trying to persecute me.

MR. CHATTERTON:

Thank you, Mr. Chairman.

CHAIRMAN MILES:

In Exhibit B that deals with determining the value, why is it that though some mathematical fluke the figure that comes out the weighted average (indisc.) just happens to be one of the figures that's up there? It just seems unusual that that would be the case?

MR. ROGERS:

Where's this (indisc.)?

CHAIRMAN MILES:

It's (indisc.) B-2.

MR. ROGERS:

By some fluke it's ...

CHAIRMAN MILES:

(Indisc.) same weighted average price that one of the independent producers -- or one of the individual producers. It just seems

strange that it would come out that way.

MR. ROGERS:

Yes, that is a mathematical fluke. This was taken personally from an actual production report and it was not constructed, it was taken -- it may have been adjusted (indisc.--cough) but this whole thing began from (indisc.--cough) and Mr. Boness created a very lengthy mathematical model of the way that the state believes the pricing should be under its leases which incidentally (indisc.) not agree and there are, as you know, four different prices stipulated in the lease; market and posted prices and the two prices stipulated in here. There is no posted price in the field and because of the way the formula works, the vague reference to market price in the lease and it probably means the weighted average of all producers in the field or something like that. It could also mean market price in comparison with totally different crude oils like Saudi Arabian crudes. No one knows exactly what not standard means so we used the two standards here which are what you see in number 9. The actual value of the oil of each producer, the weighted average of all other producers which is put in a lease to (indisc.) the inefficient or how do I say it nicely, penalize the producer who is giving a brother-in-law price to someone for reasons of his own. He still has to (indisc.-cough) price of all the other producers. It's a way of making sure that there are no bargain prices which yield an unfair royalty price to the state.

CHAIRMAN MILES:

Anybody who's concerned with government (Indisc.) Arlon Tussing made his presentation.

MR. ROGERS:

His (indisc.) theory.

CHAIRMAN MILES:

There seems to be some argument between Mr. Honig and Dr. Tussing on exactly how this figure was arrived at.

MR. ROGERS:

It could be because this gets awfully complex. This is an extremely simplified model because you have 29 producers and a lot of those producers are delivering to multiple delivery points, so the actual price needs to be done on a computer. Once you're familiar with the way it works it becomes very simple and all it means is that if you have a, b, c and d, you just take the weighted average and if the guy's actual price is higher than the weighted average of all of the other producers, then he pays his higher price. If the weighted average

of the other producers was higher than his actual delivery price then it's the other. And that's probably the practical way the formula in the leases are going to work out over the long run anyway. But I think -- I was not here for Mr. Tussing's presentation but I was not aware that he -- I thought his main concern was that by taking that \$7.03 we could do something with the oil that would disrupt the market and somehow eventually mess up the ultimate state's value utilization. Henry knows more about this than I do, perhaps he could (indisc.--simultaneous speech).

MR. PRATT: -

Mr. Chairman.

CHAIRMAN MILES:

Mr. Pratt.

MR. PRATT:

Just a comment on it. I think our difference of opinion at the time was Arlon just used three figures. This company's spending 12 something, this one 12 something and this one 11.46. He didn't use the 11.46 price to show how with that difference in there you could (indisc.) down the overall price. We were saying you don't end up with the 11.46, it's that simple. You have to weight the average of the highest with each of the producers as individuals and then weight those to end up with the price. So that the differential between what we would be paying in the highest price paid wouldn't be as great as he reflected it on the board. That's what the difference of opinion was, that he was using a vast disparity in terms of the figures that he marked down. He didn't represent them to be accurate, he said let's just use some figures, but if you look at those kinds of differences you begin to see millions of dollars worth of loss. And we're saying that's not the way it will actually work. The differential will be so small between the actual highest paid and what we'll pay that while we're (indisc.) it won't be the kind of loss you're hypothesizing.

MR. ROGERS:

My sister has a PhD in math and I think she got all of the genes when she was born and I can't figure out all of the mathematical models that all of these people (indisc.). We've got into the problems and the economic effect of removing this oil and disposing of it in some way in the interim stage and then the second phase of that is when our oil is removed from the market and processed in the petrochemical facility, there's a call for reverse ratchet theory in which it's almost a certainty that by taking the crude oil out of the market we will increase the in-value receipts of the State of Alaska by removing 150,000 barrels from the market on the West

Coast or Gulf Coast or wherever it's going and stop deliveries from the most inefficient point. And the in-value calculation under this formula will all go up and we'll all be happy and scratching our bellies.

We got lost in all of the variables when we were talking about this during negotiations and the wild price gyrations that Mr. Tussing thought are possible, are improbable because there are so many different things that are happening. The largest thing in our contract now is that when the reverse flow pipeline is put into effect it was going to reduce transportation costs from California to the Gulf Coast substantially and you're eliminating a whole lot of (indisc.) gyrations. The markets between the Gulf Coast and the West Coast do fluctuate and the earliest in our delivery will begin in 25 months and it's difficult to -- I think Tussing assumed the absolute worst that could possibly happen and that is so improbable that it's not a concern to us. It'll certainly not be motivating our debate.

CHAIRMAN MILES:

The only reason I was concerned was there did seem to be differences of opinion on exactly how this was to be calculated. We had two supposed completely independent figures, not identical.

MR., ROGERS:

That is a mathematical mistatement, not a mistatement, actually in the way his prices are arrived at, I can assure you there's no difference between the Department of Natural Resources and ALPETCO and the Department of Revenue who's been privy to all of our discussions. I think it's a very fair price (indisc.).

CHAIRMAN MILES:

Mr. Rogers, three or four days before the Commissioner indicated that he was going to recommend a contract, the ALPETCO contract. He came out and said nobody was matching what he was (indisc.). Could you (indisc.).

MR. ROGERS:

Commissioner LeResche is a very good administrator. He wrote -- probably the best way to do it would be to look at his last letter to us. That statement was preparatory to sending a letter to each of the bidders saying please change this or your contract was unacceptable and put us in the unenviable position of either accepting or possibly losing the contract to another bidder. We adopted with a few exceptions all the requirements.

CHAIRMAN MILES:

And what were they?

MR. ROGERS:

I would have to go back and and dig in my notes. If you want to give me a few minutes I can probably leaf through here and tell you what some of the problems were. The numbers were not final until the last few days. We had asked at all times for 90% (indisc.) 90% under 2.3 and 90% under 2.4. And as you can see the results 85 + potential 5% more in Prudhoe, 90% in 2.3 and 70% in 2.4. The Commissioner's concern there was that he have in reserve adequate quantities to serve future in-state needs. Those in-state needs theoretically are not necessary to be spoken to in 2.3. By definition you're selling something that's excess to the state's needs so that was the area where we were allowed to continue our 90%. The point of delivery in our minds was open until the very last, the part of the state for delivery. We always wanted Valdez as the delivery point and that was simply unacceptable to the state. The state indicated that they did not want to be in the oil business (indisc.). The charitable foundation -- I would say there were small changes that were necessary which I cannot remember at this point. The others were potentially (indisc.--poor quality of tape). (Indisc.) just making clear exactly what was to be paid into the charitable foundation, the definition of the net after tax profits. The requirement also was placed in 4.4 and one other place that prevented us from doing what the state is concerned other parties have done with them and that is to enter brother-in-law transactions at unfair prices so we put in a paragraph requiring any transaction between affiliates to be on fair terms. The storage of oil section was nullified and watered down substantially and I don't know if it's wise to speak to it because there's a question legally as to what rights, if any, the state has to storage. The state was very careful to protect itself to insure that they were not warranting in any manner that there was any storage rights. It is unclear what those storage rights were and those were some ending changes.

There were a number of changes to the measurement section but I don't think you need to be concerned with them. They eliminated a lot of standard language that did not apply because fuel practices at Prudhoe were somewhat different than standard fuel practices. A lot of the last minute changes were pulled in some final comments from a number of agencies that had expressed concerns and had read a draft. We were rushing to the end of the negotiations so many of the changes were not -- did not reflect hard bargaining or anything but some last minute comments of other agencies. The price section was pretty much in order before the end. We were agreeable to it. There were some changes to 8.2 that made clear that any costs whatsoever incurred by the state by taking in-value -- by taking in-kind rather than in-value were our problem.

UNIDENTIFIED SPEAKER:

(Indisc.)

MR. ROGERS:

Yes. 8.2 was revised in every draft and our concern was, of course, in negotiations getting a defined price of some sort to know what we would be walking into in terms of cost. The state, for obvious reasons, did not want to guarantee that a certain price would pertain and that certain costs would or would not be incurred, otherwise they would be unable to represent to everyone that the in-value price would be realized. And in the last stage of the negotiations we yielded on the point and have agreed to pick up any other costs.

MR. CHATTERTON:

(Indisc.)

MR. ROGERS:

The payments and billing section has been in pretty good shape. There were changes to 9.5 which is adjustment to billings to reflect -- we will be buying the oil and paying for it on a month to month basis and there will be some changes necessitated by possible clerical errors, mistaken reports of the producers on which the billings would be rendered, the outcome of the litigation and the state's litigation with the producers and all those were attempted to be taken care of in Article 9.5. I think they have now been done successfully except for the litigation with the producers. We're trying to cut off everything at an early period and stipulate a reasonable period of time.

CHAIRMAN MILES:

Could you go through these a little bit faster.

MR. ROGERS:

Oh sure.

CHAIRMAN MILES:

Because I want to establish what concessions did the state give ALPETCO and time-- (indisc. -- simultaneous speech)

MR. ROGERS:

I think I can answer that pretty simply. The state could not give any concessions. We were not permitted the opportunity at the very end. We were told either put those in or perhaps find the contract unacceptable so we yielded on those points except those--

CHAIRMAN MILES:

Before we get into that, were we finished with concessions the state controvened in these sessions?

MR. ROGERS:

No.

CHAIRMAN MILES:

Can you finish those.

MR. ROGERS:

I think I've covered most of them. The next big number of changes were a number of technical changes to Article 12.1 that related to the security interest. And most of those changes were initiated by New York counsel.

MR. CHATTERTON:

The State's New York counsel.

MR. ROGERS:

The State's New York counsel. There was a rather wholesale substitution of language done at the very last draft. I believe the second last draft the state had us put in new 25.1, the local hire provisions, were substituted for some other ones that had been contained in a number of drafts. And in the second last -- Exhibit D, the supplemental environmental standards, were added during the last period of time. The referendum was the very final change that was put in and that's in page 51 before I forget it. Our second last draft it was on a Mag Card and it got run through without the clause and some wrong drafts were circulated and I was accused of all sorts of wrong doings.

CHAIRMAN MILES:

You're saying that the state made no concessions at all --

MR. ROGERS:

It's my memory. If you want to call it a concession, we mutually worked out the language on page 4 and 5 with the Prudhoe oil and tried to dovetail the North Pole contract with our contract. The decided reason for reducing us from 90 to 85% was because of the needs of North Pole. They basically said well if they're not taking it, then we, because they've not been taking it under their contract presently. And the answer was yes. And the same as to the provision of the return oil. Let me think

just a moment. I can review my notes and reply. If I find some more, I will contact your office in the morning and let you know.

CHAIRMAN MILES:

When did the provision for the bottom of tank and the filling of the line get (indisc.)

MR. ROGERS:

During the arguments about delivery point we were simply unable to agree on delivery point and after a while decided to share concerns and our concern about taking at pump station number 1 was number 1, many of the carriers have lien prohibition. That was the reason why Article 12.1 is such a mess because we needed to make provision for passing the oil down the pipeline and giving the state security but not letting the oil get in a position to be rejected by the carriers because they can refuse oil that has a lien on it, even a state lien. The other concern was that we would have a bunch of oil in the pipeline that is not usable to us until we get to Valdez and it was in the nature of a compromise that we agreed to the principle of pump station number 1 if the state would agree to the pipeline fill. That is not going to be a 100% requirement under present tariff requirements. Many of the carriers provide fill for some reason that I don't quite understand and so it's not going to be a requirement that the state provide 100% of what might be required.

CHAIRMAN MILES:

Was this agreed to last week (indisc.-- no mike near speaker)

MR. ROGERS:

I don't believe so. It was agreed to in San Francisco. When was that, November?

UNIDENTIFIED SPEAKER:

December.

MR. ROGERS:

December.

UNIDENTIFIED SPEAKER:

Yes, December.

CHAIRMAN MILES:

Ms. Kallab.

MS. KALLAB:

(Indisc.--no mike near speaker)

MR. ROGERS:

As it's turned out, originally it was something very valuable to us. As I mentioned, we wanted pretty large storage. . . The more we look at it the more difficult it is to see some tangible clear rights. The storage, if it exists, is probably up in Prudhoe Bay. Nobody knows quite what the language in the lease means and the state, with good reason, insured that it has no exposure in the event no storage rights show up. It will be our job to assess whether there are any rights and whether it's worth pursuing any litigation and if there is any litigation, it would be at our cost. It is not regarded -- at the time of the contract execution it was not regarded as a substantial concession.

MS. KALLAB:

I may have missed something here, possibly. Is the storage right at Prudhoe Bay or is it both at Prudhoe Bay and Valdez? Here it says from the (indisc.) and I don't know what the (indisc.) says.

MR. ROGERS:

Well, the clause in this contract speaks to the storage rights under the lease and the answer to your question is that it's very unclear.

MS. KALLAB:

Oh.'

MR. ROGERS:

The leases themselves say that storage will be provided by the lessees, if necessary. And the rest of it you've got to write your own scenario. And it's suspected that the point of storage is at Prudhoe Bay and no one knows what reasonably necessary is. I'm not sure where this all ends us up except that I don't think the storage rights are that substantial and because of the strong interest of the state in protecting and making sure that they were not making any warranties of storage, I don't think the state thought they had substantial storage rights. We will find out and get a better fix later on whether those storage rights exist though. It was very important at the beginning and it's one of those things that has become less and less important as we have focused on the lack of clarity in the languages and what the leases probably mean.

CHAIRMAN MILES:

If the option to take lower priced oil is exercised by ALPETCO that scenario (indisc.) What happens to the Prudhoe royalty oil? Do you still own that or does the state get it back?

MR. ROGERS:

To the extent we're getting less than 150,000 barrels, we get to keep it, of course. But if in exercising the lower price we go over 150, we have to reduce our Prudhoe take and therefore the state will get either in-value or (indisc.) in-kind, free of any restrictions that portion which it gets back.

CHAIRMAN MILES:

So the state would get that back if you take a -- assuming you get up to 150.

MR. ROGERS:

Right.

CHAIRMAN MILES:

The state would get complete control of the oil back.

MR. ROGERS:

Yes.

CHAIRMAN MILES:

Representative Chatterton, do you have any questions?

MR. CHATTERTON:

I have a couple of unrelated questions. One, there's no question in your mind but what for oil other than delivery to pump station 1, point of delivery as covered under paragraph 3.1 is defined as nothing more than an agreement to agree, is that right?

MR. ROGERS:

Say that again.

MR. CHATTERTON:

Okay, any oil outside of the Prudhoe Bay crude being delivered to you at pump station 1 or the LACT meter, to make up your 150,000 barrels a day (indisc.), I think that 3.1 in effect defines point of delivery for such oil, outside oil, extraneous oil or whatever you want to use, is purely an agreement to agree. (Indisc.--no microphone)

MR. ROGERS:

No, I can't agree with that because that means that we don't have a contract on that then. I think as to any oil outside the Prudhoe Bay oil, the delivery point will be the point of delivery of the royalty oil to the state. Under its leases that means it's probably at the well head -- that is a point of litigation in the producer's litigation. It may mean at the edge of the lease. But wherever the state's taking it, we will take it from.

MR. CHATTERTON:

(Indisc.)

MR. ROGERS:

3.1 just says where's it's going to be. That's a pretty definable place, I would think. And it refers back -- it's the oil that will be sold under 2.3 and 2.4 which we've discussed.

MR. CHATTERTON:

Well down here -- delivery under this article 3.1 be made at such other points of delivery as may be mutually agreed between buyer and sellers.

MR. ROGERS:

Right, if we agree on it -- another place that the state took delivery.

MR. CHATTERTON:

(Indisc.)

MR. ROGERS:

Absent that agreement, we would pick it up wherever the state picks it's oil.

MR. CHATTERTON:

Okay, one other thing, completely unrelated. Do you happen to know whether Barbour Oil or any of Alaska Interstate's, the Alaska Interstate members of the complex, have any subsidies under the entitlements program?

MR. ROGERS:

I would assume that the Pride Refining Company, which is operated by Seatrain Lines, being a domestic refinery, has some. It's between a 35 and 40,000 barrel a day refinery so I'm pretty sure its got some. Alaska Interstate does not have any to my knowledge.

MR. CHATTERTON:

It does not?

MR. ROGERS:

No.

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman. Pride Refinery's in Abilene, Texas, Mr. Chairman.

MR. ROGERS:

I'll check and make sure of that.

CHAIRMAN MILES:

Ms. Kallab.

MS. KALLAB:

I'd like to (indisc.) -- question of exportation (indisc.--no microphone)

MR. ROGERS:

Mr. Van Ness's (ph) firm, which has been working on the DOE stuff has advised us on that and given us a pretty clear set of guidelines. If you look at the Energy Reporter, it doesn't take long. There's a definition of products that you can and cannot export. Basically all fuels are prohibited and fuels -- this is -- I'm really not a petrochemical expert so I may be using some wrong terms in the categories but I believe Naptha and Benzine are classified as fuels and are prohibited but the downstream products are perfectly okay for export.

MS. KALLAB:

Would this be available to us? (Indisc.)

MR. ROGERS:

Surely, I have it -- Commissioner LeResche has it. I have a copy at my office that I'll be glad to send you. There's a CCH export Control Reporter that I'm sure is in the Law Library here and it would be in there. If you take someone like Bob Maynard (ph) and sit him down for an hour, he could get it. I will send copies of it to you and if it confuses you, I'll send an expert in and have Mr. Van Ness explain it to you.

MS. KALLAB:

I have a couple more questions. Has the contract physically been signed between LeResche and (indisc.)

MR. ROGERS:

Yes.

MS. KALLAB:

There are physically signed copies?

MR. ROGERS:

Yes, I could not tell you where they are right now.

MS. KALLAB:

Then under 4.2, or 2.4 rather, what do you consider to be the date of execution (indisc.). What is your definition of that? On the top of page 9, yeah, line 6 or 7, what is --.

MR. ROGERS:

That I must lay at my own door step. That is my language and it was, a concern that there might be commitments made between the date of signing and the effective date of the contract. Of course, if the contract is not approved, it all becomes moot, but if it does, it automatically kicks in the -- as it turns out it's a moot concern. I was concerned that there might be a commitment. As it turns out there is none committed so that there's really nothing to worry about and it was a needless provision, I believe.

MS. KALLAB:

Okay. If you were to re-draft this contract you would (indisc.)

MR. ROGERS:

Yes, Um humh.

MS. KALLAB:

Oh, under section 5.5, subsection 2, (indisc.) the state had to provide ALPETCO with the most recent anticipated production schedule (indisc.) Since you're only getting oil or contracted for royalty oil, what's the interest in the gas?

MR. ROGERS:

I really honestly can't tell you. I can tell you where that provision came from. The language was different there and we were advised that the language was vague and we asked someone from Brown & Root to tell us what they wanted. At the time there was some -- I just honestly -- this language came wholesale from Brown and Root and

no one has questioned why we're interested in gas and I can't honestly tell you.

MR. CHATTERTON:

(Indisc. -- something about making a guess) They are in the construction business. This is public information.

MR. ROGERS:

That's what it was. Kathy just reminded me that at the time we were getting this information together there was a lot of controversy about the effect of gas production, particularly at Prudhoe Bay, on oil production. And we sort of drug a dragnet to get as much information as we could. There were some alarming newspaper reports anyway that indicated that the more gas you pulled out, the less oil you pulled out and that there were going to be some disasterous reports and this was about the time that that language showed up. I think that was the reason for that.

MS. KALLAB:

You're speaking of the Doscher (ph) report?

MR. ROGERS:

Excuse me.

MS. KALLAB:

Was that the Doscher Doring (ph) report?

MR. ROGERS:

I don't know.

MS. KALLAB:

(Indisc.)

MR. ROGERS:

I don't know the name of it, it must have been.

MR. CHATTERTON:

It strikes me that it probably was but I can't totally recall, myself.

CHAIRMAN MILES:

Could you explain the supplier-purchaser section for us?

MR. ROGERS:

(Laughter) That came from our Department of Energy wizards in Washington.

CHAIRMAN MILES:

Were they really (indisc.--laughter).

MR. ROGERS:

Compared to them I'm a perfect example of clarity.

CHAIRMAN MILES:

Just kind of translate that --

MR. ROGERS:

Let me translate it through and give you my explanation of what I think it means. The first sentence is a broad one to cover anything we've forgotten that both the state and we will take any action that is necessary to try to get the transactions accomplished. Then begins the language that is necessary to insure compliance with FEA Rules, DOE Rules. In the event that this agreement is terminated, seller and buyer, that's mainly buyer -- we have to agree that we don't mind the state terminating because there is a right on the part of the supplier to insist on a continuation of the supplier-purchaser relationship. Under the rulings that the state has received and ALPETCO has received though, the DOE has affirmed the use of an in-advance waiver of rights to continue the supply relationship. Am I talking in circles yet?

CHAIRMAN MILES:

(Indiscernible--laughter)

MR. ROGERS:

There is a right under the energy regulations -- it's designed to keep in place all of the energy distribution channels that existed in 1973. For that reason, if you have a supply contract the supplier has the right to insist on a continuation of the supply relationship, notwithstanding it's contractual agreement. The state, of course, does not want to enter the contract and be unable to terminate the contract because of Department of Energy insistence. Our standing up and saying, hey, we realize under the contract you've got a right to terminate us, but under

present federal law, you have to continue the supply relationship. So the Department of Energy has said it's perfectly okay number 1 because the Alaska production came on-stream after this frozen period in 1973 and because it's a different market and because we're dealing with the state, which is a different character of party, to waive in advance any rights for us to insist on a continuation of the supply relationship.

CHAIRMAN MILES:

Then does that -- are you saying that if the feds would mandate an interruption, you guys are out-to-lunch or the state's out-to-lunch?

MR. ROGERS:

It says that the state terminates our contract if we fail to meet our 18 month criteria. It means that we cannot stand up and and say, hey, the Department of Energy says you have to continue our oil. Well that's not a theoretical possibility because we can't get our oil until after that. Say we're at the -- this example we used before, we're at the hundred million dollar level going on to 600 million dollar level and the contract was terminated, we cannot cite as a reason to prevent the termination of deliveries, these Department of Energy guidelines. They just don't apply to us. And this language is the language that the Department of Energy says is necessary to give an advance waiver or an advance release to the state. We give you, in order to give up any rights, we have to insist on that. Then to make it even more complicated, if we were selling the oil downstream to some other purchasers, as long as it's crude oil every purchaser and sub-purchaser down the line has the right to insist on a continuation of that supply relationship, so the additional language is designed to require us to pass those same obligations on.

CHAIRMAN MILES:

I'd have to stay up all night to (indisc.)

MR. ROGERS:

I'd disclaim any responsibility for (indisc.-laughter). The first part assumes any general allocation program. The second sentence cites -- says the same thing over again but cites the present program. In order that if there's a -- I'm talking about in 26.6 we have a general sentence and then in the first sentence it talks about any mandatory crude oil allocation program. The next sentence is specifically -- we're talking here and it says the same thing over again about the present federal mandatory petroleum allocation regulations. And then the next sentence is what I talked about --

these downstream purchasers. And that's in any subsequent contracts we'll get the same agreement. The reason it's so confusing is the repetitiveness of the language, I think. Then the next sentence --

MR. CHATTERTON:

You cascade it down one more layer.

MR. ROGERS:

Yeah. It's cascaded down -- that's a very good description. Then we go from a general -- in that long sentence we're talking in general -- we'll pass on the termination provisions and in that final sentence it says specifically we will have this agreement in the State of Alaska royalty agreement as to any termination. I think after you've read that four or five times you just have to take it on faith that the principle reason it is is to allow a rather free termination of the supplier-purchaser relationship in the Department of Energy relations, without interference of the Department of Energy relations.

MR. CHATTERTON:

That's just your interpretation.

MR. ROGERS:

Yes, and they have been passed on I know by the State of Alaska's DOE counsel in Washington to insure that that's not going to interfere. It has been a constant concern of your people.

MR. CHATTERTON:

Thank you.

CHAIRMAN MILES:

On the Article 12 security clause, I have a couple of questions. What kind of a commitment or what kind of a legally binding document is the letter of credit? You know, I don't understand that insofar as a security measure goes and the second question on that is why doesn't the security apply until the crude gets down to the facility? It doesn't attach while it's in transit, yet it's your oil and so actually although point of delivery is the LACT meter, we're still liable because you're not snapping any security on the thing.

MR. ROGERS:

The letter of credit is merely a letter that will say to the State of Alaska, if these people don't pay then you notify us and we'll fund up to the amount of this letter. It will be from a reputable bank and it's better, in my mind, than the security

interest that you get from keeping the oil, because it's cash from a good bank. It's an unconditional promise to pay, it's sort of like a check, a blank -- not a blank check but in essence that's what it is. It's a blank check up to the face amount of the letter of credit. Any time that we fail to pay or that you need to go against the security because of some other reason, that's a breach of the contract, you have the right to notify the issuer of that letter of credit that they should pay the State of Alaska a certain amount of money and it will be drawn down. The specific form of the letter of credit, you'll note, is subject to the approval of the Commissioner and so it's got to be an unconditional letter of credit.

MR. OSTERBACK:

It's like a promissory note.

MR. ROGERS:

Yes, sir. And in fact it's a promissory note from a quite reputable payor that a bank issuing a letter of credit treats that on its books as if it had lent the money and it has to by regulation because it's an obligation to pay that money from that bank's standpoint.

CHAIRMAN MILES:

On the other point then --

MR. ROGERS:

The other point is rather complicated and that's part of the compromise that we reached in the pump station number 1. Three or four of the seven tariffs or eight tariffs, say the carrier has a right to reject the oil if that oil has a lien on it. Under 12.1, there is a lien retained in the oil by the seller. And for very good legal reasons that lien should not be given up until the oil has been paid for. Our problem was that we couldn't accept pump station number 1 if we were accepting oil at a point with a lien on it where a carrier might reject it. We don't want the oil with nothing (indisc.) at pump station number 1. So the contorted result was what you see here. The lien is released as to that oil on which tariffs exist prohibiting a lien and the oil would go down the pipeline and then the lien will re-attach and the complexity of that whole paragraph has been designed around and patched around to insure that at no time can we place a lien on the oil while it's going down the 9 days, down the pipeline. It was a way to satisfy our needs and make sure that we could ship the oil down the pipeline and we did as best we could to insure that the state was fully protected. The result is