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Tim: ...been able to adequately demonstrate to them by outside legal counsel that this is a way to do it. Take the royalty oil, the State's oil, and put it in a facility that's run on behalf of the State then you get Uncle Sam paying for that facility, is what it amounts to, and that's why it's so dog gone attractive. For once you get something back from that so and so who's been taking it off for a long time. This is one legal way to do it.

Tim: Taker's contracts conditioned on your achieving that (tape out)

Tim: That's why (unclear) we're ready to sign the contracts right now. It works. The deal works. (Tape out)

Lyon: Some of us would like to devote some time to other things, like little contract reading. I'd like to move for adjournment.

Triplehorn: Second.

LeResche: Discussion?

Gallagher: I'd like to know when the Alpetco contract will be available.

LeResche: Where's Connie. Did she go to get them? Does anyone know when the copies of Alpetco's contract -

Honig: It will probably be another 45 minutes.

(uncer talking - unclear)

LeResche: When those are available we'll make them availabe in

this room which will still be open so you should all be here if you want a copy about 5:00. We'll just lay them out on the table. We'll deliver copies to the Board Members.

Lyon: Will we pick the lock to get in?

LeResche: (unclear) Isn't the front door unlocked? Okay, all those in favor of the motion to adjourn - aye. Opposed.

The meeting is adjourned.

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LeResche: Okay, we're coming to order now. I might suggest that everyone who wants to hear sit as close to the front of this room as possible. It's a barn and there's no amplification system. So especially those of you who want to hear the people who are going to have their backs to you come up.

We'll call the meeting to order and say it for the record that all members are present as well as the executive director. Joe Moore from Bonner and Moore is on his way in from the airport now. That was one reason we delayed the meeting. The other reason was we couldn't get in the door in time.

With the approval of the Board I'd like to deal with two measures before we get into the other two contract proposals and Bonner and Moore Report. The first of these is a resolution (tape out) of the Board Members of their objection to having a meeting called in 13 days notice rather than 14 days notice as the Bylaws suggest. Would anyone like to bring this up for action?

Lyon: I'd like to move for adoption.

Warwick: Second.

LeResche: Is there any discussion of this?

Warwick: Is this - never mind. The document explains itself.

LeResche: Okay. Any further discussion?

Lyon: Question.

LeResche: The motion's been called for. All those in favor of the Waiver of Objection Resolution - Aye. Those opposed - It's been unanimously adopted and somebody who has a clean copy let's just sign it.

(under current of talking)

LeResche: With Mr. Warwick's signature this is now an official meeting and so was yesterday. The other thing we have to deal with is the final draft of the Finding to Take Royalty Oil and Gas in Money or In-Value. This was distributed at the last meeting. It's newly required by the statutory revision of last year. And I hope you have all had a chance to look at it. Essentially it runs down all of our State oil and gas leases, summarizes the current status regarding the State's royalty share, the alternatives if any to our taking in value, and a finding for each field. Would anyone like to bring this up for action or discussion?

Lyon: There is no copy of that in our packet today.

Warwick: I think we had one set yesterday.

LeResche: Yes, it's the draft with a very few changes, typo changes and stylistic changes.

Wold: They did have a copy last time - copy - the old copy.

LeResche: Right, it was passed out at the last meeting.

Warwick: Mr. Chairman, I move that the findings be approved.

LeResche: Is there a second?

Lyon: Second.

LeResche: Okay, any discussion on these findings? (under current talking)

LeResche: Okay. Commissioner Gallagher asks that we table this until later in the day. He hasn't had a chance to consider it. Is there further discussion on it?

Lyon: Until later today though?

LeResche: Okay. We will then just delay this until later in the day. I think I saw a very tan Joe Moore come in the door. There he is. Welcome, Joe.

Okay. I would like to just move along then to a presentation of the contract proposal by Alaska Petrochemical Company.

Honig: You're out numbered.

LeResche: You can't scare us. (Laughter.)

Honig: Mr. Chairman, Members of the Royalty Board, we didn't intend to scare you on purpose. We did bring a lot of people here to Juneau and there have been comments from time to time about the large number of people we have taken to see Smith Barney or Joe Moore or anyone else. We've done this because from the very beginning we have been serious about this project and from the very beginning we have tried to bring aboard experts in each of the fields that are involved in this effort and this endeavor. We brought a large number to Juneau because we hope that we would be the choice of the administration and we knew if we were we could not go further without your blessings. Our

people are here to answer any questions about the project which you or anyone else may have. Most of them have been here since last Saturday. Most of us will stay as long as necessary to conclude your questioning. We have agreed to spend our time, effort and money to fulfill this contract because it will be a profitable business venture for us. We are interested in making profits. The State of Alaska will incur no risk nor lose any money in the process and when we succeed we think that the gain to the State will be substantial and it will be permanent.

We have a slide presentation in an effort to speed up our discussions. And those gentlemen at the table here will be addressing various areas in their various areas of expertise. We would like to discuss ownership (that says outline okay - that's ownership), benefits to the State of Alaska, viability of the project and a brief summary.

The first is ownership. Alpetco is owned by three companies, Alaska Consolidated Shipping, Barbour Oil and Alaska Interstate. As you can see Alaska Consolidated Shipping each of six Native Regional Corporations own 8 1/2 percent of Alaska Consolidated Shipping. We have some of the presidents of those Native corporations here today, some had to go back, but I believe that from Calista Oscar Kowalgy is here - right here; from Chugach, Bob Anderson; from Cook Inlet, Roy Huhndorf; and is Perry Eaton here from Koniag, Inc.? I guess not. Each of those gentlemen are president of their - also we have George Miller who is Chairman of the Board of Kenai Native Association. (unclear question from Board)

In addition to the Native groups Seatrain Lines, a New York Stock Exchange Company owns 49 percent of Alaska Consolidated Shipping

and from that company we have the Chairman of the Board from New York who came out Saturday, and has been here, Joe Kahn, from New York City. We also have Jim Strupp from Seatrain Lines who will speak later.

Seatrain is in shipbuilding, it's in container transport, it's in ship charter, it's in port management and has an oil refinery which is about the size of (unclear) in Texas. Seatrain and the Native groups formed Alaska Consolidated Shipping over a year ago and, as you know, made application over a year ago for the crude oil. Fred Notti is Chairman of Alaska Consolidated Shipping. Perry Eaton is vice-chairman of Alaska Consolidated Shipping.

We, Alaska Petrochemical, have no sweetheart arrangement with Alaska Consolidated Shipping. They are a stockholder, they are affiliates, we will work together and they have been terribly helpful in helping us with all shipping aspects, and our understanding with them is so long as they can do the job and are competitive they will certainly do the shipping. The second company is Barbour Oil, which is a privately held company in Houston. We were all saddened recently with the unexpected death of John on his way back to Alaska from Tokyo, and it's a great loss to all of us. No one, I think, had more dedication to this project than John. So when the refinery is built we plan to name it the Barbour Refinery in his honor.

The third company is Alaska Interstate, which I'm also chairman of and it is a diversified company. It started doing business in Alaska in 1959 through its subsidiary in Anchorage, which is Anchorage Natural Gas and Alaska Pipeline. We're also in gas exploration and liquifaction in Indonesia, we are in oil and gas exploration in the United States,

and we have a company that does engineering and construction of gas processing facilities, pollution control and sulfur recovery processes. We also have some manufacturing subsidiaries.

So those are the principals who own the amounts shown of Alaska Petrochemical.

First.. - Next we would like to talk a little about the benefits to the State of Alaska and we have a list of them there which starts with no risk; no subsidy; additional employment; additional taxes; the Alaska Endowment Trust we have agreed to form; our shipping capabilities; the specialized training we have already begun; labor policies in general; and controlled industrial development.

On the first item - no risk to the State of Alaska - we're proposing no subsidy, no price concession. We have included in our capital estimates the ports, docks, utilities as offsite items, but they're included in our numbers. There will be no interim take of crude by Alpetco unless and until we have a commitment for at least one and a half billion dollars of permanent financing. In addition to that we have already obtained a favorable opinion from the Department of Energy, which protects the State in the event we do take crude oil and have to stop taking it, and this opinion says yes the State can take it back from us. This was obtained by Bill Van Ness's firm in Washington. Bill was here until last evening.

Probably the biggest protection to the State in terms of no risk is in the area of what we call performance benchmarks which we developed with the Commissioner's staff some time ago and put in the contract. This is a brief resume of these. If at any time any one of

these is not met then the State has the right to terminate the contract with Alpetco. The first two items simply refer to reporting. During the first six months after the contract is approved we will provide monthly progress reports to the State, to the Commissioner of Natural Resources. Thereafter, after six months, we provide quarterly reports. At the end of six months we must have invested at least 2 million dollars in this project. We must have finalized the site selection by reporting to the Commissioner our first choice of site, which the Commissioner has the right to approve or disapprove; and we must begin optimization of the design of our plant.

At the end of twelve months we must have invested at least three million dollars. At the end of eighteen months we must have invested or committed to invest at least 10 million dollars. More importantly, we must have contracts for the sale of at least 70 percent of the output of the plant. This eighteen month criteria are benchmarks as you see, is the critical ones, really. In addition to having 70 percent of the output contracted for, we must have obtained financing commitments for at least one and one-half billion dollars. Firm, permanent financing commitments. We must have completed our EIA, we must have filed for permits everywhere we need to file, and we must have finalized the plant design. So if we have not done all of these things in eighteen months then the State has the right to terminate the contract with us and until we have gotten the financing committment, which is key because we cannot get that until it is put together, we may not take any interim crude.

Then we have additional benchmarks. All of these we set

purposely and with the knowledge of the Commissioner as minimums, not as what we hope to do or what we expect to do, but as to what we must do as a minimum. Twenty-four months we must have committed or caused third party contractual -contractually bound third parties to commit at least $100 million into the project. By 30 months we must have commenced construction; 36 months $600 million; 48 months $1 billion; 60 months, $1.2 billion; 72 months, $1.5 billion. Those are the benchmarks in the contract and probably the most important thing about the contract.

We might look at some of the other major contract terms. Since our economics, our planning and our financing are based on using 150,000 barrels a day, Alpetco will purchase royalty crude under the terms of the contract, up to 150,000 barrels a day from two sources: one - from no more than 85% of the Prudhoe royalty oil. Now this was reduced twice - initially down to 90 and later to 85 - as I understand it to make room for the needs of North Pole refinery. The next item is that we may take up to 70 percent of other royalty crude oil in the State if we need it to make up any shortfall. We may take it up to, but take it no further than the 150,000 barrels which we are designing the facility for. So it is simply because we had to reduce the amount of Prudhoe Bay oil we could take and to assure us that if this large investment is made in the plant that we will have a right to other royalty crude which may be discovered in the future.

The price terms, as we've mentioned, provide that we will pay the same in-value price plus a reimbursement of any costs the State may incur by taking the crude oil in kind. If the State incurs a cost it does not have now, then to keep the State even we must pay that.

The point of delivery was a discussion for quite some point of time, and we have agreed to the point of delivery the State wanted which was Pump Station No. 1. And I think understandably, or primarily, because the State and the Royalty Board did not want the State to become a shipper.

We have provided in our design and we are commited in the contract to provide at least 30,000 barrels a day of fuels for in-state use.

In the environmental section we not only have agreed to comply with all Federal and State rules and regulations which you would expect; but we have also agreed to meet supplemental State standards whether or not required by law. That is important to the State now because there apparently is some question about some of the environmental requirements the State wants to keep in place and we've said whether we have to or not legally we will comply with those standards. The one that is written in there, and also I'm sorry to say to say was missing from the contract that we reproduced, and the laywers promised me it was because of mag-card difficulties in Juneau, but at any rate we did agree to the Governor's request that if we at any time want to amend or modify Article VIII, which covers price and all its ramifications, then we would be required to do so via a public referendum.

The next item which is a benefit to the State is additional employment and additional taxes. And I would like to ask Willard Hanzlik, who is a vice president with Alpetco to discuss those two items.

Willard Hanzlik: In making the preliminary planning estimate of employment which will be permanent in the State of Alaska as a

result of the facility we called on both Brown & Root and Chem Systems, each of whom has experience in working in similar facilities or at least components of the contemplated projects (unclear) and have established a range of jobs which they believe are consistent with other similar projects with minimums and maximums of numbers of permanent jobs.

I think you can see the first item, refinery which is comparable to a (unclear) refinery (unclear) with a range from 450 and 550 employees on a permanent nature. As we move into units of the petrochemical facility each of these items below here - aromatics, olefins, polyethylene, etc. represent employment structures of petrochemical facilities as a substantial number of jobs. These are numbers which are as I say are consistent with comparable projects on a world wide basis and the aggregate, we are talking about between 1900 and 2500 permanent jobs. At this point in time it is impossible to narrow down definitively much more accurately than that because the question of re-evaluation of that sort of thing will effect final numbers.

We have previously in previous presentations talked about maintenance jobs. These numbers 800 to 950 jobs are included - spread along the components (unclear)

To summarize the new employment - the additional employment which the project will bring to the State of Alaska in the construction phase which (unclear due to a cough) about three years will average in the neighborhood of 2,500 to 3,000 jobs. These are temporary jobs as such. They are not permanent jobs - but the operations phase which will be 20 years or so - are permanent jobs and the petrochemical facility, the number we have just referred to on the previous slide, together with

the shipping arm (unclear) Alaska Consolidated Shipping representing 250 to 350 jobs, a total of 21 to 28 hundred permanent jobs with the project. (unclear) these numbers are not conclusive of additional jobs and jobs that will develop as a result of support businesses developing around the facility and estimates vary on this. A common rule of thumb is a three to one ratio so it is again premature to speculate on that. It's going to be a matter of (unclear) as a result of siting (unclear).

We've ...talked a lot about direct tax benefits to the State of Alaska. A common result is a substantial investment, the profits of (unclear) facility and here points to on an average basis what the property taxes on a 1% rate will (unclear) locally and along with State corporate income tax and gross receipt tax would mean an average per year of the contract period. These numbers come out of our financial projects submitted to you in October and (unclear) understand that those are definitive numbers, they are representative of what can be expected of a project of this scope and are probably accurate with some reasonable (unclear)

Again, these do not include any of the indirect taxes that will come from other investments made by others or from personal income taxes paid by employees of either Alpetco or other businesses. Incidentally, we have prepared a set of these for each of the Board members.

One way to look at what does a petrochemical facility mean in comparison with a average or normal sized fuel refinery look at imperative investment and imperative jobs. I apologize for the fact that our scale

is such that it doesn't all fit on the table. What we have tried to show in proportional representation in this column, over here, say $750 million investment for fuels refinery and about 500 direct permanent jobs resulting. On the same scale there is a petrochemical facility at say 2.5 Billion with 2,200 direct permanent employees. All that is there to show is the significance difference in terms of the new capital base for tax base to the state and also the impact of new jobs.

Honig: Thank you, Willard. The next benefit to the State is (end of tape)

Honig: ...environmental conditions in the State of Alaska. The reason for this trust was that rather than propose that we pay a direct premium per barrel on the oil before we built the facility and as it operates in the early years, we propose that instead of that that we contribute after ten years of operation, we contribute five percent of the net after tax profits each year into this trust. That estimated contribution would average about $10 million a year based on our projections and model that we furnished you in October, and in ten years that would be $100 million into the trust not counting any accumulation of interest. The administration of the Trust we have agreed would be by an independent board of directors unaffiliated with Alpetco in any way. They would be appointed by the Governor and confirmed by the Legislature and this is another provision in our contract.

The next benefits to the State we listed are shipping capability and specialized training for Alaskans. And I would like to ask one of our members who worked with us day and night on this project to talk

about those and that is Jim Strupp, who is Vice President of Alpetco and Vice President of Seatrain. Jim.

Strupp: As Mr. Honig indicated before, Alaska Consolidated Shipping will act as Alpetco's shipping arm and function in that role in several ways. One; ACS will provide specialized ships for products manufactured. There is enough lead time in this project to construct specialized new vessels optimize the transportation on this project. Two; we will provide career opportunities for Alaskan citizens in the maritime industry. As Mr. Hanzlik has said, we are looking at 250 to 350 jobs in the maritime industry for Alaskan citizens. We will talk about that a little more in just a bit. We feel we have the experienced management in ship building, as you know Seatrain ship building located in Brooklyn, New York and employs 2,600 people building crude carriers as well as barges and other transportation vessels. We have experience in ship chartering and we have a very experienced staff in port operations management.

The majority of Alaska Consolidated Shipping as you know, is owned by six Alaska Native regional corporations. We think backed up well by Seatrain Lines, one of the largest shipping companies in the United States.

I would like to talk now about our plans for specialized training for Alaskans. Some of it is already happening. In the area of shipping several months ago John Gunderson, a member of the Aleut Corporation and a Director of Alpetco, and I had lengthy discussions with the Harry Lundeberg School down in Piney Point, Maryland. They were quite intrigued with the chance of training Alaskan citizens in the maritime industry

and as of right now we have enrolled, and they are currently in school, two students who will be graduating at the end of March in basic seamanship. Those two students are Mr. Ray Clock, who is a member of the Doyon Regional Native Corporation, and Mr. Fred Hawes of Cook Inlet. The school works from this standpoint. Alaska Consolidated sponsors the airplane transportation to the school and then the school funds the training while the student is there. When the student graduates he is guaranteed a job.

In addition to this training we also wanted to begin in the exposure of some citizens here to refinery - basic refinery techniques - so we have for the last two and a half months had two trainees being exposed to all basic refinery principles at the Pride Oil Refinery in Abilene, Texas. They have been going through a job rotation program and been covering all of the operational jobs, quality control, lab jobs, maintenance jobs and getting a total exposure to basic refinery techniques - doing a lot of work. Talking to them on a weekly basis and they are going to come back up and help us in terms of further recruitment in our training programs down the road. At Pride Refinery we have Mr. R. C. Credo, Jr., of the Sea Alaska Native Corporation, and Mr. Loren J. Hoyt, of Cook Inlet.

Our plans in the shipping area, after discussions with the Harry Lundeberg School, is that they will begin taking more and more students whenever we want to send them. On the specialized training that is planned there will be extensive training programs for Alaskans as I indicated on all phases of shipping, plant operations, plant maintenance. These are considerable programs. They involve a lot of technical training.

We plan to go through this at the appropriate time. All of these training programs will be coordinated with Brown & Root, Chem Systems, Alaska state officals and labor union officials in the State.

Thank you.

Honig: Just a moment on the next slide, Willard.

When John Barbour and Jim Strupp and I were working, getting together our team and our management we decided early on that for a project of this size we would need someone to work with us in the design, engineering and construction phase. Some company that not only had done this before, many times, but a company that had a large enough net worth and balance sheet to make their statement that it would work and run worthwhile to not only us but buyable by our investment bankers and the people who would buy the bonds. So we needed a large company and a capable company, and there are only about three around that are large enough, I think, to head up some effort like this. So we associated early on the firm of Brown & Root and we have a slide that gives you some basic data about Brown & Root.

They have offices around the world. They are one of the largest and most diversified engineering and construction companies in the world. Last year they did the largest volume of any construction company. They are a subsidiary of Haliburton, which last year had revenues of 4.9 billion dollars in '76 and the shareholders' equity was 1.4 billion dollars and maybe they are embarrassed about their profit but I recall it was after tax 306 million dollars. They are experienced in Alaska. They did the North Slope production facility for BP, which was very largely fabricated on the Houston ship channel and was one of

the pioneering jobs to show how much you can prefabricate and bring to Alaska. They were in a joint venture with two - for the two northern most segments for Alyeska Pipeline and they are currently building an industrial complex for the Big-3 Industries, all in Alaska. They are very experienced in design, engineering, construction of what we are talking about, which is refining, petrochemical facilities and offsites. I would like to call on their senior Vice President, Jimmy Norris, to talk a little about labor policies and the environment. Jimmy.

Norris: Thank you Charles. I guess after that introduction that we don't have to say too much about Brown & Root except we consider ourselves an Alaskan company. We've been in Alaska for about ten years continuously now and any of the construction work we intend to do here will be done through our subisdiary, Alaska Constructors. This is the group that John meant - alluded to - when he talked about the British Petroleum work and the work that is now going on near Anchorage.

Alaska Constructors is associated has signed the Alaska plan, associated with the AG's group. Our relationships with the Alaskan workers and unions has been good. I've had these people say that we are a fair company, sometimes I can't remember their first names but we get along pretty well. As to the Alaskan company we intend to maximize Alaskan workers on this project. We don't intend to bring anybody in that we can hire here. We will work within the existing State and labor guidelines for the training of workers. We will forecast labor requirements by craft as far in advance as possible to allow for this particular training.

May I have the next slide, Willard.

It doesn't quite all go on. Well, just show me the first part then. That's good.

This is a very preliminary plan that show employment for both construction, then the blue would be the phase in between the maintenance and the construction and the start-up operations, and then a combined plant operations maintenance group. That shows a number - I think it's something like about 3,000 if you could read the chart there. We never find one of these curves that is that flat. They're usually peak a little higher and this one probably will but for a short duration, but that shows 3,000 people now and will probably go up a little bit - something close to 2,000 people for the operations and the employment and quite a number of the operations and maintenance people can phase in from the construction operation with very little training.

Now I'd like to address myself to one other aspect. This seems to be one of the things that has come up in our travels around Alaska. The people are concerned with the environment. They are concerned with the controlled industrial development. What we want to build is a clean environmentally safe facility. Now I've been doing this sort of business myself for thirty years and I've watched the Houston ship channel grow to where it only had a few chemical/petrochemical facilities to where now it is probably the largest in the United States in the collection of industrial facilities. It's grown so much that there is no more room on the ship channel, we're spreading to other places. We would like to see this in Alaska. We think this is probably the ground floor of what Houston did some thirty years ago.

One thing I want to talk about when I say that Houston is the

largest collection of petrochemical facilities. I want to say that it is an environmentally clean. There is relatively no pollution - industrial pollution - in Galveston Bay. There's still a little bit by the city of Houston, but they are rapidly cleaning that up. I say this because I live down there. I moved my home from the west side of Houston down to Galveston Bay. I live down near the Space Center where my wife keeps crab traps out in the front yard and we catch more blue crab than she can cook. Furthermore I'm a big fisherman and further down the bay I have a fishing camp. This particular fishing camp is located right within a fishing village. This is a group of people who make their living fishing, crabbing, oystering. And over the six years that I've watched that I've had that place I have watched that bay clean up and the fishing and the crabbing has gotten better and better. This is the type of facility that we see can happen here in Alaska; except that you won't have to go through the clean-up phase. You'll start with a clean plant.

Finally what we're talking about - Willard mentioned the high capital investment and the number of employees that you would get in this type of facility - it's a highly sophisticated industry; requiring high capital investment for employees. It's an industry that is synergistic - that is, by its very presence it's going to attract more people with to build more facilities. So I guess that's about the end of that. I'll answer ask for questions later. Thank you.

Honig: Thank you Jim.

So we've talked about no risk; no subsidy; additional employment and taxes; the Endowment Trust; shipping capabilities, specialized

training, labor policies and controlled industrial development.

There was an editorial in the Anchorage paper Sunday that I think sums up better than we can what the benefits to the State are. I'll take the time, if I may, Mr. Chairman, to read this editorial. I don't think you can read it from there. But I think it does sum up this entire section on benefits to the State of Alaska - and it's not written about any particular company. It's by Bob Richards who is an economist and Executive Vice President with Alaska Pacific Bank.

"This week the administration is to deliver to the Legislature its recommendation regarding disposition of the State's royalty oil.

"Although several experts have questioned the viability of the four proposals before the Royalty Oil and Gas Development Board, it should be noted that the four bidders have been working closely with the State over the past few months to develop plans that make sense for all parties. Now consultants Bonner and Moore [Associates Inc.] have concluded that at least three of the four contenders are 'fully qualified.'" I'll let Joe Moore speak to that. I don't know whether that's accurate or not.

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

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

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

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

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

petrochemical industry in Alaska will help considerably to reduce the overall seasonality of employment in our state.

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

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

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

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

"Perhaps I can summarize by acknowledging the general positive relationship between our 'quality of life' objectives and our economic

development. Here we have the opportunity to encourage an industry which will bring wages, highly skilled, well educated people to stable employment and which manyfold more than pays it[s] own way in terms of social impact. The social and economic attractiveness of the petrochemical industry is self-evident."

Next on our outline is to talk about - we've talked about ownership, we've talked about benefits to the State, we now like to talk about the viability of the project. We are dividing that into four subjects: management, description and scope, marketing and financing.

On the matter of management we call this chart the development phase of Alpetco because that's really what it is. We've been criticized for not having experienced, seasoned petrochemical executives aboard our ship and the criticism is certainly warranted because we had to have that kind of person or those kinds of persons. But it's impossible when you are an applicant among many to recruit career, seasoned executives. You can get consulting firms but you can't hire chief executive officers when you are just one of many applying to someone for something. So we weren't able to get until recently someone who had been down the ropes as a chief executive of not only a petrochemical plant but a chief executive putting these sorts of things together.

All along we have had all of the people you see there with the exception of Gordon Cain and with the exception of ChemSystems. All the rest of those people have been working with us since our beginning of the project.

In the technical area we now have ChemSystems. We have had all along Miller & Lentz in Houston who are reservoir engineers. We

have a Vice President of Alpetco in the technical area - Hilton Lacy, who several of you know in the gas processing area. In marketing we have had Bill Strong, formerly with DuPont as a Vice President in our company since the beginning. We now have ChemSystems bringing their expertise to that area.

In the legal area Eddy Rogers has served as our special counsel and later Pat Dyer from Alaska Interstate has helped him. In Alaska our counsel is Cathy Chandler, who has been a great help to us from the very beginning.

Early on when we became interested in exploring Japanese markets we associated Joe Tyding's law firm in Washington to advise us in Washington and in Japan. Bill Van Ness's firm has been a counsel to us all along in the area of the Department of Energy and it was his firm who prepared the application for and received the successful opinion on the matter of our taking crude and not upsetting the State's position.

Jim Strupp has been with us from the very beginning in the area of shipping.

Engineering and design, I mentioned Brown & Root. Jimmy Norris you have heard from. We also have with us today and he's been with us everywhere we've gone, including Valdez and Japan, and that's Gary Montgomery who is project manager from Brown & Root.

In finance, Bill Anderson, who couldn't be here today, is a Vice President of Alpetco. He's also the chief financial officer of Alaska Interstate Company. He's a former senior vice president of Blythe, Eastman, Dillon, in corporate finance energy in New York. Raymond Trobh was at our Royalty Poard Meeting in Anchorage earlier and

is a financial consultant to many companies including Alaska Interstate. He is also a director of Alaska Interstate and recently became a director of the American Stock Exchange.

From the beginning we have had E. F. Hutton and Kuhn Loeb - now Lehman Brothers, Kuhn Loeb - as our investment bankers and both of those companies have known us for a long time because they have been investment bankers for Alaska Interstate; and in the case of Kuhn Loeb also for Seatrain.

Chemical Bank has been with us from the beginning and they've made all the rounds with us and all the Royalty Board Meetings with us and have served as our commercial bank for interim lending and other purposes.

In legislative matters Henry Pratt has been with us from the beginning as has Terry McCall who is a Senior Vice President of Alaska Interstate and a Vice President in Alpetco and first came to Alaska with John Barbour on this proposal.

Willard Hanzlik is in planning and he's backed up by not only ChemSystems but two of our computer and planning experts in Houston.

On the matter of training for local hire backing up Jim Strupp has been Ron Dagon in Seatrains as well as the Pride Refinery which Seatrain owns in Texas. I believe it's about a 35,000 barrel a day refinery.

So that's our organization. I'd like to mention a few things about ChemSystems. They did not join us at the beginning but came in on all fours in December. ChemSystems we carefully selected. We didn't know anyone in the company but we did talk to a lot of chemical and

petrochemical people who placed them at the top of the list as being the leading firm specializing in both marketing and technical support of not the refinery industry but the petrochemical industry. They have offices in New York, London, Munich, Houston, Paris, Sao Paulo and Beirut. They have a staff of 80 professionals plus of course the usual support personnel. Their clients include most of the world's leading oil and chemical companies, as well as several national governments. They are experienced in petrochemical project development worldwide. The same kind of thing we're talking about here - including in the United States, Western Europe, Japan and Middle ~~East.~~ They're experts on supply and demand and the economics of petrochemicals both in this country and around the world. We have been very fortunate in having both the president of that firm and one of their senior vice presidents, Chuck Campbell, work with us almost constantly.

The next person I want to mention in our organization is a - has newly joined us and we did a lot of looking around to find someone that not only had been down the chute in terms of being a chief executive officer of something like this, but also someone who had successfully put these together - which is entirely different from running them and administering them. And we knew we could not at this stage, before we were even selected by the administration, we could not at this stage bring someone in, some career person in, from a petrochemical company unless we found someone in a particular situation. Gordon Cain's name kept coming up at the top of just about everybody's list we talked to and so we approached Gordon about having an interest in joining us. We had consulted with him on two previous occasions about this project and

he had been very kind to advise us on it. And Gordon studied it and he talked to a lot of people, including Joe Moore and including by the way Peter Spitz, the head of ChemSystems, they are all in the same industry, they have known each other for years. And Gordon decided that it was do-able and that it would be a challenge and that he would like to do it.

He's had over thirty years in the petrochemical industry and he has been, as I said, responsible for every phase of it. He has been in market development in major petrochemical facilities in the U.S., in Japan, in Europe and in South America. He has negotiated with the Japanese on just what we're talking about here in the past -- and successfully. He is presently employed as the chief executive officer of Petro-Tex Chemical Corporation in Houston, a company he organized some time ago. He left that company and became head of the chemical and petrochemical division of Continental Oil which he served for many years. He was one of the organizers of a joint venture in South America among primarily chemical and some (end of tape)

Cain: ...it is highly likely to include an aromatics plant and an olefins plant. In addition that it be downstream facilities to ~~convert aromatics (tape bla~~nk)

...It's one thing to build this facility but the key question is can we dispose of profitably the products from it. And I think we can and I think I should say that we don't have any intention of going out and hiring a lot of sales (tape problems - then tape blank)

...comfortable in being in the position of depending on someone else for their basic raw materials and very many of them have aggressive

campaigns to get more basic in raw materials. And so I have talked, Mr. Spitz has, Mr. Strong has and we've had a number of strong expressions of interest on the part of chemical (blank) both in the United States and in Japan and so we expect that these satellite facilities will be joint ventures with chemical companies from either the United States or Japan. (tape blank)

...such that it would be worth while for them to do this and you've heard about ChemSystems before and I can add to this that I have known Peter Spitz, well ever since he started his firm some 10 or 12 years ago. The fact that he was involved was certainly a significant factor in my agreeing to (tape blank)

Spitz: ... the major project for the United States as well as for Alaska. And I want you to think not about the current situation in oil and petrochemicals where there is a sort of a glut of oil on the world market, as you all know, and there is a not a glut but certainly an ample supply of petrochemicals available, but I want you to think about the years 1985 to 1995 and beyond when the situation, everybody believes, will be quite different. Studies made by a number of respected agencies, the Department of Energy, the CIA, (tape blank)

At that time the possession for the right to buy from large amounts, say 150,000 barrels a day of crude oil is going to be worth a great deal. And it is that factor more than anything else that has caused Alpetco to be very interested in this project for itself as well as for Alaska. Alpetco's studied the possibility of building either a refinery or a petrochemical plant and when you do that you very quickly come to the conclusion that as far as supply and demand of either fuel products,

petroleum products, or petrochemicals is concerned the very likely choice would be to build a petrochemical facility.

I'd like to see the first slide. This is a representation of the expected growth rates for petrochemicals versus fuel products in the United States. If you look at the bottom part of the slide it figures the growth rate over the period '75 to '80 to '80 to '85 and so forth, you see that the growth rates for fuel of products, the petroleum products are actually very low. They go down to less than 1% a year. Lower actually even than the expected growth rates (tape blank) to use less oil and is trying to shift it's oil requirement from - it's energy requirement - from oil to whole and nuclear energy. And so it turns out that there really isn't a tremendous demand for new refineries in the United States. And in fact, somebody from Shell, not too long ago, said that in the early '80's will be the last refinery that will ever be built in the United States. Now that may be an exaggeration, but it's not probably too far from that. On the other hand, the growth rates for petrochemicals go lower than in the past - and in the past they've been in the range of 8 to 10 percent are still going to be quite high. So when you think about where petroleum and petroleum feedstocks are going to be going, they are going to go much more likely into petrochemicals than into refinery products. And, furthermore, the refineries that are going to be built are going to concentrate more and more on making petrochemical feedstocks than for instance gasoline, because gasoline will actually experience close to zero growth after '85 with cars becoming lighter and more efficient and also with prices for gasoline going up. So the conclusion that we reach is that the U.S. needs many (tape blank)

therefore building a petrochemical facility is a more desirable thing to do for the future. Let's take that slide off.

Now the next point is does petrochemical manufacturing in Alaska make any sense? We think it does, of course. And I believe I'm right in saying that Joe Moore believes that it does under the proper circumstances. I believe in one part of the report he says so. I want to talk about this a little bit right now.

The conventional wisdom is that petrochemicals in the United States are made in the Gulf Coast because they've been made there for a long time. And the reason for that of course was that the Gulf Coast is a very inexpensive petroleum and natural gas and gas liquids and that this lead to the preponderance of these plants being built on the Gulf Coast. And that includes, of course refineries, but particularly petrochemical plants for making olefins and aromatics.

Now in the rest of the world the major petrochemical manufacturing facilities are in Western Europe and in Japan. Alpetco is not interested in the Western European market - it's too far away - we are interested in the Japanese and the Pacific Basin markets and so I'll really talk more about the U.S. and the Pacific Basin in this part of the discussion.

It's become quite obvious that the Gulf Coast will suffer a decline in its petrochemical growth mainly because gas and oil running out are becoming much more expensive and in fact some of you may not even know that - several large petrochemical producers and oil companies are making plans to ship large amounts of coal to the west Coast. A rather startling development but certainly one that will without a doubt happen in the '80's and '90's. They know that oil is going to be hard

to come by and that the government is putting all kinds of pressure on producers to switch to coal. Now there has been another problem of having all these petrochemical plants on the Gulf Coast in the U.S. - which is that markets have grown all over the United States and yet most of the production facilities have remained in the Gulf Coast. And a very good example of that is the West Coast market, which is a very large market, and which at the present time does not yet have a petrochemical plant of any size.

Now looking at the rest of the world, the petrochemical plants in the past were located pretty much close to the market but in the future will be more and more located where the crude oil is produced, or where the gas is produced, because the producers of oil and gas are getting in a sense more and more leverage from the fact that they do have these raw materials and they would like to get the kind of industrial development that we were talking about earlier in the presentation - that we believe Alaska should be benefiting from. Moving to Japan - Japan has problems that are also becoming fairly severe. They are running out of space to build plants while growth rates are still continuing. Furthermore, they are having problems building up too high a trade surplus. They would like to buy more things from the United States and one of the things they could be buying from us are feedstocks and primary petrochemicals which would be good for the balance of payments. So the message here is that petrochemical production facilities are going to be built more and more where the crude is, where the crude owners want to build these facilities and not necessarily where the markets are even though this may not be as economically

favorable in all respects when you look at the entire chain. You will note that the OPEC nations are thinking about building petrochemicals and we think this will come very slowly but it is a good example of this situation.

The next point is - and there has been talk about why - there have been letters written in some of the newspapers here. . . it's ridiculous to build either refineries or petrochemical plants in Alaska - this is against all economic sense ... you are going to be shipping petrochemicals all over the world ... this is going to require all kinds of subsidy, etc. - well the fact of the matter is that petrochemicals are already traded all over the world. The flow of petrochemicals from various parts of the world to other parts is immense. Aromatics are shipped from the United States to nd Japan and Western Europe currently in very large quantites. Butadine goes from Japan and Western Europe to the United States. Chemical intermediates like styrene and vinalchloride are shipped from the United States and Japan to various other parts of the world. Even ethylene is starting to be shipped in chronogenic tankers, though we don't intend to do this here, but it's another instance of a structural change in the industry.

The people who trade these chemicals all over the world are the multi-national companies, U.S. trading companies, and particularly the large Japanese trading companies, whom - at least one of whom - possibly more of which will probably play a fairly important part in this project. The Japanese requirement for materials is also one that we ought to dwell on for the moment because it really consists of three parts. People have said, well Japan doesn't need petrochemicals, it is

very well supplied. It has enough production facilities for a long time, it's not sensible to expect the Japanese to buy petrochemicals from the U.S. or from Alpetco. But the fact is that it's not just the Japanese domestic market, the Japanese export market is very large and will progressively have to be supplied from other places than Japan. Furthermore the Japanese trading companies move materials all over the world and whenever we at ChemSystems get into a new project anywhere, we are almost sure we will hear from one or two Japanese trading companies who say we will take the output of this plant, or we will take half the output of this new plant, because we need this material to move it to Europe or to Latin America, and so forth. So think of the Japanese requirement as a global requirement and not necessarily the Japanese market.

The Japanese also have as a matter of policy started to decide that they also really got concentrating on the downstream chemicals - the chemicals where more value is added because they import all their raw materials, they have - as I said - a limited amount of spaçe for new plants, and they furthermore have a number of older, more antiquated facilities and than they feel with rising unemployment that they ought to concentrate more on downstream materials and whether they now start to import primary petrochemicals instead of crude oil and naptha may not make much difference to them. That, we think is another plus for the Alpetco project.

So, looking at the question then of does it make sense to make petrochemicals in Alaska, we have an established world trade, a growing need for more petrochemicals on the West Coast and in the Pacific markets

from a plant that has an insured crude supply and what we think is a favorable geography.

Now I would like to just show you what we mean by the West Coast market - and that is shown on the next slide. It is a market that consists of 28 million people, about 3/4 in California, the rest through the other West Coast states (it of course includes Alaska) but by far the largest number of people are in California. This market is almost entirely supplied from the Gulf Coast petrochemicals shipped down around the Panama Canal and up the West Coast, or else in hopper cars by rail, which is a very expensive form of shipment, and if you think about the geography shipping down from Alaska to this market, which needs petrochemicals badly, is an emminently sensible proposition. Now, the Pacific market, as shown in the following slide, consists of quite a large number of countries. At the top there is Japan and Korea, which are reasonably self-sufficient, but which have a growing market and will need more products because they are already at a high base. You have many countries with a developing population, such as the Philippines, Malaysia, Singapore, of course Hong Kong, etc., these are areas that are starting to import fairly substantial amounts of petrochemicals from other parts of the world. A lot of them have come from Japan in the past but Japan has become less competitive and a lot of the materials are being shipped in from the Gulf Coast now, and therefore represent good opportunities for a project in Alaska. And our studies on West Coast and Pacific Basin imports show that this is a very interesting market which a week ago after together with companies that are already U.S. companies and Japanese companies that are already in this market.

Now I would like to now go on to the question of supply and

demand - because there again has been a certain amount of criticism that this project will make products that are not needed by the world and it doesn't make sense to manufacture petrochemicals here when there may not be adequate market for them. While the petrochemical industry is not cyclical in terms of employment, because it provides very stable employment, there are periods of excess supply and excess demand. And it will probably be that way for a long time to come and just because right now the pendulum has swung a little bit in the direction of too much supply it was only three years ago when companies were literally fighting with each other to get the last pound of polyethylene or styrene and there is no reason to think it will not reoccur in a few years when the current surplus of (unclear) capacity has been worked off. The key point is that the petrochemical growth rates, while lower than in the past, are still enormous and I think the next slide will give you a very good illustration of that.

The three most important petrochemicals are ethylene, propylene and benzene. The U.S. demand currently for ethylene is about 27 or so million or billion pounds, which will be about 31 billion pounds by 1980 and if you look at the projections, and these are not we believe very optimistic projections, they are lower than Stanford Research projections, they are lower than Arthur D. Little's projections, just to mention two companies that do this kind of thing - you see a requirement going from 31 billion to 85 billion pounds of ethylene in the year 2000 and comparable growth rates for the other petrochemicals. These growth rates come about because petrochemicals grow much faster than GNP. There are still many applications for them, for example in the packaging industry only about 6 or 7 percent of packaging materials are currently

made from plastics and many people think this can get up to 30 or 40 percent level and that in itself could account for 1/3 or 1/2 of this growth. And when we contract these growth rates to the Alpetco expected production of ethylene, propylene and benzene, they do sort pale into significance. I'm not saying that these aren't large amounts of material than can be sold quickly - I'm merely putting them in prospective against U.S. requirements and not even total world requirements.

Now in the next slide we look at ethylene a little bit more closely. This is a chart that was actually published by Union Carbide. On the left side we see the billions of pounds of supply or demand and along the bottom the years and we see that supply and demand go up with each other as companies install incremental capacity. It appears that every three years or so the supply is always used up and so new plants are required and this gives us an estimate, for example, that just between now and 1990 fifteen new ethylene plants will be required in the United States to meet this kind of growth rate. And, again, we're talking about one such plant for Alpetco and for Alaska, which does not seem unreasonable, and four such plants for the West Coast.

Moving then, to the West Coast market where we have carried out a large amount of study work - on the first slide we show generalized demand growth curves for several major petrochemicals such as polyethylene, styrene, vinal chloride and ethyl glycol, and these are substantial amounts of polyethylene, for example, going up to a 3 billion pounds per year requirement by 1990 (if you move that up a little bit) and Alpetco who ought to be very well located to serve this market would hope to get perhaps no more than 20 percent of the West Coast polyethylene market

and perhaps comparable amounts of some of the other chemicals. This is also shown in the next slide where we have actually contrasted supply and demand for three petrochemicals on the West Coast, and you see for example that ethylene demand will go from 1.7 to 4.5 billion pounds in 1990 and the current supply is negligible.

There is a very small ethylene plant on the West Coast. The reason I put the 250 million pounds in parentheses in '85 and '90 because I feel sure that sooner or later there will be one or two West Coast plants that as you know they've been held up for a long time for various problems - Dow recently gave up in their attempt to build one there and even though we think there will be some plants built eventually, the market opportunity there is very good and the economics for shipping these materials from Alaska to the West Coast is certainly as good in our judgment as shipping them from the Gulf Coast.

Moving out to the Pacific Rim Basin - again on supply/demand and on opportunities for Alpetco - the Japanese market is tight right now. There is surplus capacity there but when we went around to a lot of the Japanese companies, and of course to the government, and to the Japanese Energy Commission and the Ministry of International Trade and Industry there was a tremendous amount of interest in this project. In fact, the surplus in some of these materials was almost belied by some of the statements that were made by some of the major companies. For example, Matsui Trading, which is a 30 billion dollar company world-wide told us, and wrote us a letter, which will be distributed with the other letters to members of the Royalty Board, -- anyway they told us that Matsui will face a shortage of olefins and aromatics sometime in

the mid to late 1980's and would be extremely happy to start taking materials from an Alaskan project. Similar letters were received from other companies.

I think the slight negativism among industrial people that Commissioner LeResche saw in Japan and reported on, was perhaps at least partly influenced by the fact that when a company, which is certainly true right now - a number of companies in Japan are suffering from a slow growth in petrochemicals and have surplus capacity, it's difficult for them to see more than a year or two ahead while they are having problems working off their excess capacity. We see the same thing in the United States very frequently. Operating companies are very much influenced by what happens in this quarter and this year and they worry about their p and l's for the current year and sometimes have difficulty focusing on a situation six to ten years ahead. But, the government agencies are in a little different situation. They have been extremely supportive of this project as Joe Tydings will talk about in a moment.

Now Japan is therefore one area we are going to concentrate on very heavily. We are also going to try, as I said before, to sell materials in other parts of the Pacific Basin and in the next slide we have summarized the results of some of our studies on the type of imput requirements that we see for the Pacific Basin countries for 1985 and we see the need to import namely - [illegible] uld be a net deficit when you add all the demand for these areas and subtract the known production capacity. We see a need of 1.4 billion pounds of polyethylene, 1/2 billion pounds of polypropylene, and so forth. So these are again interesting markets for an Alaskan project.

The next slide then shows again the number of ethylene plants that we think will be needed in this entire region. This is the net deficit and we see that by 1990 (and now I'm really just focusing on the West Coast and on the Pacific Basin) ten plants will be needed to make up the deficit for ethylene and again Alpetco plans to build only one of these. The West Coast and Pacific Basin market will therefore need a large amount of new capacity and when I look at our projects, which is shown in the last slide, I think you will now perhaps agree that a) there is a market for a number of different products which I won't get into because you've heard these names before in this speech, and a lot of these different areas and that the project that we are planning - Willard, I'd like to see that last side, please - does not make an excessive amount of these.

I would like to just go over that with you briefly. The plant is designed to make approximately 4% of U.S. plus Pacific Basin requirements (1985 requirements) of aromatics, about 3% of total requirements of olefins, and the downstream facilities we are thinking about and these are typical because we're not sure of our product slate - none of them make more than six and in most cases 3 or 4 percent of the U.S. and Pacific Basin market requirements for these materials. Now the olefins plant I'll say one more thing. While we plan to currently crack petroleum feedstocks to make olefins, Alpetco is going to design its cracking furnaces flexibly enough to be able to crack gas liquids because we know that there is a possibility if and when the Alaskan gas pipeline is built that gas liquids such as ethene and propane could concieveably be extracted (end of tape) Kenai ethylene depending on which feedstock turns

out more economical. And so, I want to stress the flexibility that we are proposing to use in designing this plant. The approach on marketing, which was discussed by Gordon Cain, is one that I personally feel that is very likely to be successful, namely to find one or two (tape blank)

help coming of our next speaker who has a tremendous amount of background in Japanese matters. This is Mr. Joe Tydings, a counsel to Alpetco, who has been a consulate to the Condron, the Economic Association in Japan, the Japanese Energy Council. He's been a special counsel to the Japanese Embassy on U.S. trade relations, and for seven years he has been a counsel to the U.N. Fund for Population aActivities. I would like to now introduce Mr. Tydings who will talk about what we've been doing in Japan.

Tydings: Thank you Peter. Chairman LaResche, and members of the Royalty Board, I'm reminded of an old Maryland proverb that the mind can absorb only so long as the seat can endure - and I wonder whether it would be in order for the chair to entertain a five minute seventh inning stretch so that the members of your Board - or I can go it either way..

Mr. Chairman, you have heard from Peter Spitz, the economics of marketing in the Japanese area (tape blank)

...Japan and the United States and also the strategic problems of Japanese industry. Given the needs of the Japanese economy it is almost inevitable that given the opportunity there will be a Japanese and a strong Japanese participation in this project. Since World War II as a result of many factors, including United States manificence, Japanese

industry and initiative - the Japanese have built a remarkable industrial economy. However, the fundamental precept of that economy is the importing of raw materials, the adding of value in Japan and then the exportation of those raw materials. The basic raw material of Japan are those raw materials which relate to energy. Take a little look at history. Thirty-seven years ago you can see how important Japanese leadership felt an embargo of oil was with respect to their continued health.

Today we have a situation where the Ministry of International Trade & Industry predict that the increase in demand for oil or the derivatives of oil will be something like 1 and 1/2 million barrels a day between 1978 and 1982.

The Japanese political leadership since World War II has been entrusted in the hands of one party, the Liberal Democratic Party. That party is very closely alligned and associated with the business leadership of Japan. They interface on a daily basis and their top officials move freely back and forth. It was almost inconceivable that a steady source of petrochemical feedstocks in the mid 1980's would not be the subject of decision making at the highest level of Japanese industry and Japanese government given the strategic importance of fuel, energy related fuel, in Japan. The fact that no offical of Alpetco set foot in Japan until October the 3rd, that in three visits negotiating - preliminary negotiating visits - Mr. Barbour met on two of the three occasions with the Prime Minister of Japan gives you an indication of the importance and the strategic importance of a steady available supply of petrochemical feedstocks to the overall well being of Japan.

You tie that to the present problems of the United States/

Japanese trading relationships, which are perhaps caused by many factors, but the bottom line is that for the past few years the deficit in U.S./Japanese trade balances has been such as to cause concern at the highest levels of our government. Within the past two months two separate deputations from our own government - the Rippers (?) and Ambassador Strauss - all to explain and in public fashion - the need for Japan to materially increase their purchases from the United States if the Carter administration is to be able to hold off the forces of protectionism which are mounting in our Congress and throughout our country. Anybody who watches the steel caucus shoe caucus, the textile caucus, the number of protectionist measures introduced within the United States Congress in the past two years know that this is a very real problem indeed.

So you have with the Alpetco proposal a unique timing. A timing of a facility for which Japanese participation for the Japanese would not only mean, as Mr. Spitz has outlined, an opportunity to participate in a very viable economic endeavor but an opportunity to secure and to participate in securing a steady, dependable supply of petrochemical fuelstocks over a period when the shortage of fuel and energy in Japan will be very, very material. In the United States we have briefed top career civil servants in our own government on the basic proposal of the Alpetco project. Without exception the initial reaction from our top career civil servants and this is State, Treasury, Interior, National Security Counsel - has been that it is consistent with the fundamental direction of U.S. international trade policy; that at such time as the State of Alaska makes a definitive decision with respect to the competing proposals before you, that top decision makers would meet to consider

what steps might be appropriate in light of the United States' vital interest, with respect to further discussions between United States and Japan with respect to trade matters. No commitments or anything like that. Just plain common sense and the understanding that this is the type of proposal which needs the scrutiny and study at the highest levels.

The sum total of the timing of this proposal is that quite aside from the economics, quite aside from the great Japanese ability to make money in trade, that the timing is such as to make Japanese participation almost inevitable. Now we will distribute, and I think - Will, - have we distributed the letters, the last group of letters? We have strong indications of interest from one of the Japanese trading companies, Nissho-Iwai, whose sales last year were over 26 billion dollars; we have interest from Mitsui which already has been spoken of by Mr. Spitz; we have letters from Marubeni Seoto (sp?). Bear in mind the first preliminary discussions with the trading companies didn't take place until really January. We have strong letters of support, of course, from governmental officials. And I think in the last analysis, the facts of the world conditions and relationships between the United States and Japan and the very real strategic needs of the Japanese economy as such, indicate that quite aside from the economics of this Japanese participation given reasonable opportunity by Alpetco is assured.

LeResche: Okay, thank you very much....we'll reconvene at 2:00 p.m.

Meeting recessed until 2:00.

LeResche: Will the meeting please come to order. Mr. Honig, please proceed.

Honig: We'd like to put up the outline we showed you at the beginning this morning, of our presentation, and that still should be ownership on the top, and the next is benefits to the State of Alaska, next is viability of the project and finally, summary. To remind you where we are now, we have been talking about viability of the project and we've discussed the management, the description and scope was discussed by Gordon Cain, marketing was discussed by Peter Spitz and the political aspect of marketing by Joe Tydings. We would now like to address briefly the subject of financing.

As I mentioned earlier, we associated immediately on getting into the project - last June - we associated with E. F. Hutton and Kuhn Loeb as co-investment bankers for the project. Both were already bankers for Alaska Interstate Company, and Kuhn Loeb also for Seatrain. The other reason we associated them, not just because we knew them and they knew us, but each has had extensive experience in the field we are talking about here. Particularly in the tax-exempt financing and particularly in large project financings involving energy companies.

To talk to you about the permanent financing, both conventional as well as tax exempt, I'd like to call on Tom Kenny, who is managing director for what is now Lehman Brothers, Kuhn Loeb, and he is assisted by John Vickers, who is a Vice President of E. F. Hutton. Tom.

Kenny: I feel just a little bit like the place kicker in the waning moments of a football game when the opposing coach calls a time out to make him nervous. But the analogy really isn't true here. Two

reasons: first of all E. F. Hutton and ourselves are not unaccustomed to being in the position that we are in at the present time, and that is advising businessmen concerning the financial soundness of an important project such as we have at the present time; and secondly, and perhaps most importantly, as Charles says we have been involved in this right from the inception and we have not changed our minds one bit, have not altered our thinking at all concerning the financial soundness of this project.

Charles says I'm a Managing Director of Lehman Brothers, Kuhn Loeb. This is a relatively recent firm created by the merger of two important banking organizations, both of which were created in the middle part of the eighteenth century...ninteenth century. I'm a hundred years behind, and.. Both Lehman Brothers and Kuhn Loeb, during the more than one hundred years they were in existence , I think it's fair to say, were certainly in the forefront of capital raising in the American capital markets for industry and we intended the combined firm will continue to be so. Our partners in this chore of advising, structuring and implementing the financing for this project, E. F. Hutton & Company as represented by Mr. Vickers, is by most measures the second largest of the full-line investment houses and also by most measures is the most successful of such full-line investment houses. E. F. Hutton has some particular merit and standards and expertise in the flotation of tax free issues. We anticipate that in this roughly 2 and 1/2 billion dollar capital requirement that we have here that as much as perhaps 300 million to 350 million of it may be acomplished in tax free issues. In connection with this an in depth study has been prepared concerning the

availability of such tax free financing in Alaska which I have a copy of here. Some of you may have seen it. We certainly have copies available to anyone who would like to see it.

E. F. Hutton and now Lehman Brothers, Kuhn Loeb - incidentally it's known as Lehman Brothers, Kuhn Loeb in the United States and Kuhn Loeb, Lehman Brothers every place else. That's an interesting compromise. You might have guessed about the negotiations that went into that one.

We've written letters early in the game concerning what we thought was the financial soundless of this project. We've written further letters elaborating on the earlier letters. We prefer to stand by the letters that we wrote and are prepared to say to you at the present time that we don't feel any differently and that feeling is that given the Alpetco approach to this project it can be successfully financed, that appropriate capital costs with the conventional important financial institutions primarily in our judgment in the U. S. capital market. Now in this market we anticipate that the financing will be structured as the project financing. The project financing, generally speaking, will have more debt in its capital structure than a normal business enterprise. It will do this for two reasons. The first of which is of course is it is a sensible business scheme in the first place and we've heard lots of that this morning. The second and perhaps more important is that we would anticipate support, financial support, with respect to this capital structure because of executory contracts which would run to users of the output of the facility. This project financing would be accomplished over a period of time that's going to stretch for several years and will be done in several discrete financial increments. We

anticpate that they will aggregate, as has been said here before, a total of approximately 2 1/2 billion dollars. In our judgment given the nature of the project, the type of financing scheme that we contemplate here, the time frame of which we're going to accomplish it that it can be readily accomplished.

We do expect, as was earlier mentioned here, participation in this venture by the users of the output of the facility. We would anticipate that the participation that these users have might very well take the form of equity interest in various parts of the project as it was been described. This would not be unusual. Quite to the contrary this would be something that would not surprise us at all. It would be a quite normal arrangement. We were asked during these negotiations what we thought about the availability of equity monies for this project, and we have written a letter on the joint letterhead of KL and Hutton, a copy of which is in the update that was delivered to you gentlemen, I believe in the last several days, in which we say that we believe that any necessary equities for this project can in fact be raised readily. There are two matters I would like to emphasize concerning financability which I've heard about in the past two days during these hearings that I think are probably essential in accomplishing the financing and certainly in pushing the financing beyond the stage that it is at the present time. That is I'd like to emphasize that we cannot reasonably expect the progress of this financing to proceed any farther than it has without an award of a contract. And the second is that I believe that it is also essential that the supply of the crude oil be assured just as much as it possibly can via, of course, the initial contract and also

that the option, if it's necessary to - and if it's available, of course, to build the supply up to the originally contracted for amount.

Charles, that's all I have to say.

Honig: The other part of the financing we have someone here to comment on is the part of the financing that most of must be done between the time that we break ground and the time the project is completed in phases. This is called construction financing or interim financing, and we have with us John Mazzuto, of Chemical Bank in New York. I keep introducing him as a vice president. He keeps missing that promotion and I believe is working on it again. John Mazzuto.

Mazzuto: I'm not sure I'm happy about that introduction or not. I'll have to think about it. But just a fe words about the Chemical Bank for those of you who are not familiar with it. We are the sixth largest bank in the United States; we have at approximately 1977 I think $31 billion in assets. $105 million dollars in net income. We consider ourselves one of the leading financial suppliers of monies in the United States to orporations such as Alpetco and Alaska Interstate.

Before I talk for a few minutes on the various financings that we have been discussing over the past several months - one thing I would like to make very clear. That these financings that we have discussed and we have committed letters to are not esoteric and they are not exotic. The type of financing that we deal in day in and day after. They're sort of a plain vanilla in our language.

There are three financings I would like to outline briefly. One deals with one of the partners in this venture and two others deal with Alpetco. We realize within Chemical Bank that original monies are

usually spent on these projects in the form of equity contributions. Mr. Honig of Alaska Interstate has asked us to consider what type of debt capacity his company could offer as to equity contributions. We have submitted to him a commitment letter that Chemical Bank would lend as part of the bank group $100 million dollars to Alaska Interstate for equity contributions to this particular project. Twenty million dollars of that money would be available on day one upon execution of the contract. We feel that the additional funds between our $50 million commitment and up to $100 would be easily obtainable within the U.S. bank market. We have discussed with other banking institutions on a general concept basis how we would do this and they are in agreement that it can be done.

As to Alpetco - one of the necessary ingredients here is a construction financing loan - the as you build it before the permanent financing comes in on take out. On the stage basis that this project is being presented, we believe that a $400 million credit would be adequate which would be obtained by a group of banks lead by Chemical Bank. We have indicated to Alpetco that the Chemical Bank out of that 400 would be willing to commit $100 million dollars of its resources. Again, we have discussed this type of credit with other colleagues in the banking industry. We think it's a - I wouldn't say simple- but is a type of credit that we see every day and we believe can be put together in an orderly manner.

The third financing that we have analyzed is that when the Alpetco group reaches certain benchmarks and it starts marketing the interim crude oil. Our studies have indicated for the amount of crude

oil marketing sales and payment terms that have been discussed heretofore that a line of credit in the amount of $100 million dollars would be sufficient to finance such an operation. Again, we have committed in writing to Alpetco that the Chemical Bank believes that $100 million line of credit could be set up and the Chemical Bank would be willing to take up to $50 million.

All these commitments that we have made, and I believe they are in letters that are available, - I'm sort of emphasizing again, there's nothing exotic about these, there's nothing esoteric. They're subject to a credit agreement. The credit agreements that we deal in day in day after - it is a thing we follow all the time.

I guess my piece is very short. My concluding remarks are -- start with my beginning comment. We believe that the commercial bank role financing within the Alpetco project is one we are familiar with, and two that we feel fairly confident can be accomplished in an orderly manner.

Honig: I failed to mention that both John and one of the senior vice presidents of the Chemical Bank were with us at the Royalty Board Meeting in Valdez and the other member of our team, Gren Paynter, was unable to get here for this meeting, but has kept in touch with us by telephone and is also very interested in the project.

One other thing I might comment on in the area of financing that I think deserves clarification perhaps to some, and that is what our position is and what our plan is with respect to joint ventures which have been mentioned from time to time. This is just a for instance if we can get it in focus. The center part there with the three boxes -

the center box says "core refinery". Just to call it a "core". Then the box on the left says ports and docks and the box on the right says utilities. Let's just take those for a moment.

It's quite possible, both on the financing and on the ownership of some of these off-site facilities, that they could be owned by someone other than Alpetco. Perhaps a municipality, if there were interest, could own the port and docks facilities. The financing backup is going to be identical. It will be the credit of the Alpetco project that makes it possible whether it is owned by Alpetco or not, and the availability of tax-free financing is no different in this case. So those are possibilities.

Then we show other boxes off the core refinery and one says aromatics up at the left and the one on the right says fuels - it shows both domestic and other. And these are possible areas of joint ventures. Below the "core" refinery we show olefins plant #1 and olefins plant #2 and those might be a joint venture where we would bring in a chemical company to own part of the olefins unit and Alpetco own part of the olefins unit and form some joint venture. So, the main purpose of this chart is not only show that such things are possible but that this is what we are talking about when we say this kind of project lends itself to attracting ancillary and related other businesses and also indicates our willingness to take partners in who bring as Gordon and Peter said, who bring talent and knowhow and money and markets to the table.

I'll ask Gordon Cain if he will summarize for you briefly. Gordon.

Cain: John I suspect that it's a little relief to hear that

this is a summary which ought to suggest that we're nearly finished. All of us have a tendency to think about the future as though it's just a simple extension of the present. And if we thought that the conditions in the oil and petrochemical business five years from now would be the same that they are today there would be clearly no reason at all for us to be here trying to persuade you to let us sign a contract for a large amount of oil for a long period of time. We understand (unclear) ... we have sold you and that is today it's very difficult to take market price oil refine it and make any money. And we suspect that Mr. Wetzel will tell you shortly that there's a big over supply of petrochemicals. But we're not talking about (tape out) ....now, I think all of you know that the informed opinion is that sometime in the eight years this current surplus of crude oil will be converted into a shortage. And that when this shortage is either honest or is evident then at that point having this substantial commitment for feedstock in a politically stable area will be a valuable piece of paper. And it is with this asset that we think the - it is this asset that we think gives a high probability to the success of the Alpetco project. It is our plan by the time - by 1984 - to have a facility that will supply the fuel requirements to the State of Alaska, that will produce petrochemicals that at that time will have a favorable market environment. The things that we plan to produce are all now growing at a rate of six to ten percent a year and the output of this plant will represent less than five percent of the total Japanese/U.S. market. So we think that at that point the market conditions for this plant output will be favorable.

We've also said to you, and I think it should be clear, that

we are not uniquely astute in recognizing that sometime in the middle 80's this supply of hydrocarbon feedstock is going to be very valuable. There are other people who recognize this also and we're confident with the help of these companies who are very much interested in this hydrocarbon feedstock with the organization that is being built up, with the support of the owners, with the help of the State of Alaska, we can make Alpetco and Alaska a significant factor in the world petrochemical business.

Thank you.

Honig: We would like to conclude with a list of the Royalty Board goals as mentioned by Governor Hammond in his speech on the 19th and we think that Alpetco has met all of these goals. First - no less money for the oil than the State receives in-value; second, no subsidized sales; third, an in-state facility for processing the royalty oil; fourth, a minimum risk to the State; fifth, comply with strict environmental standards; sixth, provisions for job training; and seventh, commitment to hire trained Alaskans.

Thank you, Mr. Chairman.

LeResche: Thank you all. Does the Board have any questions, public members?

Lyon: It's nice to know that if we did we have 29 people here who could answer.

Triplehorn: ... mentioned a figure of financing to the extent of 2.5 billion and yet the contract now specifies 1.5 billion - I assume that's (unclear) previous figures in the earlier version.

Honig: Dr. Triplehorn, let me give you my understanding of those differences. There has never been any change in Alpetco's position as to what we wanted to build. I think we came along initially perhaps a little too rigid in talking about the exact configuration of the petrochemical complex. If we did, we didn't mean it. We gave everyone a book which had pictures of vessels and pictures of different parts of the petrochemical complex and I think if we'd left the impression that it was rigid we wouldn't change that at all. That's not the case obviously because it will have to be modified in various configurations making more of this and less of that as we line up partners and sales contracts for products. But whatever configuration all of our people have always been convinced and still are convinced that it's going to cost at least 2 1/2 billion dollars. Now the 1 1/2 came into play when Commissioner LeResche and his staff said we want some benchmarks in this contract. You don't have it all signed up and put together and ready to break grown tomorrow - we want some benchmarks, we want some requirements progress requirements as you go along. These should be minimum requirements; and they are. both in time and in dollars and in other measures so we said don't set them if you can't make them. So when we set a billion and a half that did not mean that we cut the refinery down. It meant that we've got to meet that or you can cancel the contract. And we also said as we looked at these - well you get to the eighteenth month and have a financing commitment then I can relax or the State can relax because the bankers are going to see that it goes from there to they commit money - and that's correct. At one time there was a misunderstanding when we mentioned six hundred million dollars and people said

well you've cut back on what you're going to build. Well, we hadn't at all. And later in a subsequent conversation Commissioner LeResche, looking at the benchmarks, and he was one who felt we had cut back earlier, looked at the benchmarks and said well I'm not concerned after you get the six hundred million. I don't think we need to put those other numbers in. And then he realized why we had said six hundred earlier.

So these are just minimums and they are guideposts or progress marks that we have made. But they don't represent any curtailing down of what we planned initially. Does that answer your question, sir?

LeResche: Don, let's see if the Board members have any questions.

Wold: I just had one add-on, ... that also means you're not committed to build anything more than one and a half plant.

Honig: That is correct. That is correct. I am advised, however, by Brown & Root and by ChemSystems and by Gordon Cain that to build what we are talking about is and that's an academic number because it's going to be more than that. There's no way to build what we talking ...

LeResche: Yeah. I might add the commitment - it's also in words in the contract as to type of facility.

Honig: Yes, but, but not - we're not tying the configuration of it down. We don't know how much of ethylene and pyroethylene we would end up (unclear)

(unclear)

Lyon: Sir, we have - we're going through the contract (unclear)

and I guess I don't feel like I'm quite through too far enough in case some of you will be around tomorrow in case something else comes up.

Honig: Yes. Not all of our people can stay but I will be here and Peter Spitz will be here in the technical area.

LeResche: I think it would be important if your attorney could be here, too, if that's possible.

Honig: We will work on his plans. Are there any other particular areas that Commissioner you would like us to have people here for - such as finance or engineering or construction or

Gallagher: As for myself I'd like to know what the contract (unclear)...any questions of a non-technical contract word nature.

Lyon: It's a shame to have all that power sitting there and not be able to ask a question.

LeResche: You're wrong, that's the talent, here's the p[illegible]r.

Lyon: Mr. Honig, your team has done its work effectively.

LeResche: Thank you all very much.

LeResche: Okay. The next side we're very glad to have our Pardon me - you're not next. We're glad to have Joe Moore from Bonner and Moore here and he's agreed to give us a very short summary of his report and to be available for Board questions on the record this afternoon. Joe.

And I would ask speakers to speak up and anyone who's having trouble hearing to come closer.

Moore: Mr. Commissioner and Members of the Board - I have submitted my written report to you some weeks ago and most recently I

submitted an update of that report in the form of a letter which commented on some additional developments which had been made in the Alpetco group since the date of my evaluation. At this time I will just comment on our conclusions and summaries of our report and will not go into the details.

Our report first concentrated on the question of what the likely in-value price of oil would be to Alaska in the future. Since the objective of one of the policy statements of the Governor has been that the State will receive at least the in-value price of crude oil and that our charter was to determine the economic characteristics of these projects it was necessary that we first get some idea about what the range of in-value prices are likely to be in the future. Those numbers are a part of our report and they are used in subsequent comparisons where we determine on a pro-forma basis how each of these projects might be able to afford to pay that price. We are trying to put ourselves in the shoes of perhaps a financial institution - how viable these projects would look from an onomic standpoint given the objectives of the State of attaining at least the in-value price of the crude oil supplied to this project.

We determined that four separate categories of evaluation would be used. Our purpose of breaking our evaluation procedure down into four categories was because the relative importance of these categories are almost a matter of policy and certainly of subjective evaluation. How each of these projects meets the overall objectives of the State of Alaska is certainly not a matter of direct calculation because many of the objectives of the State are not readily quantifiable.

The four categories we choose to describe these projects are first - economic viability; second, management; third general business merit - which obviously is a catch-all phrase intended to describe you Night the viability of the general business plan. And then the fourth category we listed as a probability of implementation. Which was an attempt to put into one category all of the doubts and uncertainties which might accrue to either of the projects which would determine whether or not any of them ultimately became implemented.

In terms of economic viability we made a calculation using certain standard economic parameters which enabled us to back calculate the price of the feedstock which each of these projects could afford to pay based on some standard market prices for the products and then we choose to compare that back calculated affordable price to the in-value price of the crude oil. As I mentioned, the in-value price of the oil covers a substantial range which is effected by the outcome of the present litigation concerning the payment of field costs for the oil and secondly by the future logistics which determine the ultimate transportation cost of Alaskan crude to its ultimate destination. The lower those transportation costs being the higher the in-value price being to the State.

In terms of economic viability, and now I'm speaking always in terms of our report as amended by the letter to Commissioner LeResche, that the order of economic viability would be the Alpetco project and the Alaska Petrofining project essentially comparable and clearly viable from an economic standpoint. Thirdly, would be the Alaska Petroleum Company proposal which is somewhat less attractive economically but

still I would consider it to be financially viable by normal measures. Now I must emphasize that these criteria are one dimensional. When I say economically viable that is to say if you get this price for the product and you sell a volume of the product then that proves as an income. It's sort of like saying if you have ham we'd have ham and eggs if we had eggs. So the economic viability does not speak to the question of whether the markets really exist of whether the projects can actually be financed.

The second category was that of management. In terms of management we classified Alaska Petroleum Company first. The reason for this was very clear cut. Alaska Petroleum is the only large corporation proposing to build a project in Alaska which is presently in the business of refining crude oil and marketing it. The parent of Alaska Petroleum Company Coastal States is quite a substantial member of that industry and as such is clearly qualified with substantial resources to provide the management that their project would require. I might also say that in evaluating management we took into account the problems they had to work. I think that as my other comments will indicate building a crude oil refinery is less of a developmental problem than building a petrochemical facility. So although two companies might have the same quality of individuals if one of them tackles a harder job we would say that their management is less qualified relative to their ultimate objective. So in an absolute sense we are not necessarily saying that someone who is lesser qualified has incompetent people - but rather that they may have tackled a harder job.

The second project or the second group that we ranked in management was Alaska Petrofining. Third, Alaska Oil and Chemical and fourth, Alpetco. With the exception of Alaska Petroleum Company each of these other three groups could be called promotional groups. That is they are companies who have or syndicates or partnerships who have been formed to pursue a specific investment objective. They do not represent major companies who are simply expanding ongoing operations. Now in terms of their management capability, or their management resources, I think it's useful to try to add a dimension of what in an absolute basis is the depth or the adequacy of this management given the general context of the proposal. Alaska Petroleum is clearly proposing to expand their supply of crude oil, they are qualified to do this, they have management depth, and therefore they come out ahead. The other three groups are developmental groups and in terms of what other typical developmental groups look like I think they all three have quite adequate management resources. Now they certainly don't compare to an ARCO or a Shell or someone who is already in the olefins business. But compared to other developmental projects I think that all three are adequately managed for this phase of the project. And I think all four are qualified to tackle their project in the sense that they have been represented to the Board.

The third category, general business merit, we categorized Alaska Petrofining as being particularly well qualified in terms of their business plans and we felt that they were particularly well qualified because they recognized, as did all the proposers, that there were certain unique economic situations in Alaska brought about by

geography, cost of construction and so forth, and that there had to be some answer or some property of their proposal which would overcome these characteristics of the problem. Alaska Petrofining in our judgment had a very effective and somewhat unique business plan that effectively answered the problems that the location in Alaska poses - at least on a current basis. The general business merit of the Alaska Petroleum Company was ranked second. It was ranked second because - or it was ranked highly - because it simply represented an extension of a present business and as such was founded on a fairly strong business plan.

Third Alaska Oil & Chemical Company and fourth Alpetco at this time I would say that their business plans are much more similar than they are dissimilar. I think both of these companies - I couldn't at this point distinguish their business plans. I couldn't rank Alpetco third and Alaska Oil & Chemical fourth. I think that at this point the business plans are comparable and I would rank them comparably. I will say one thing in view of the presentation that we have heard here today. My prior exposure to an Alpetco presentation was the one in Valdez - and particularly since I have modified certain of our evaluations with regard to Alpetco I would like to say that I have been much more favorably disposed towards Alpetco's general approach toward developing their project. I had some considerable concerns about it earlier. I feel that it's quite professional at this point.

The order of the probability of implementation - essentially I ranked the two refineries more likely implementation and the two petrochemical projects less likely of implementation. I ranked the Alaska Petrofining Corporation first on the basis that their economic

looks strong, they appeared to have their market well defined and within reach, and their project in general seems to be at a more advanced stage of development. Alaska Oil and Chemical Company I ranked second primarily on the question as to whether or not the parent company Coastal States would ultimately decide to invest in Alaska relative to other investment opportunities they had. Yes.

LeResche: Alaska Petroleum is the one who has Coastal States as a parent company.

Moore: Pardon me. Alaska Oil and Chemical Company I still rank second.

Alaska Oil and Chemical Company was ranked second because of the proposal they made which is you accept their crude oil purchase terms would clearly be a financable proposal and would be one which they probably could implement with regards to their business plan. Thirdly - excuse me, the Alaska Petroleum Company was ranked third because of uncertainties as to whether or not the investment opportunity in an Alaska refinery would be favorably compared to other investment alternatives that their parent Coastal States would have. The Alpetco proposal was ranked fourth.

Now if we were to say that both Alpetco and Alaska Oil & Chemical Company would be subjected to the same conditions regarding the purchase of crude oil then I would probably reverse the rankings of the two chemical companies - well I would change the rankings around quite a bit - the oil companies would be the most likely - the refineries would be the most likely projects of implementation - the Petrofining first Alaska Petroleum second and the two chemical projects being less likely

of implementation with Alpetco ranked third and Alaska Oil & Chemical ranked fourth.

. I would sum up the our evaluation this way. We really have two kinds of projects that are proposed. These two kinds of projects represent substantially different business circumstances. Refineries are dealing in commodities where the competition is essentially a price competition and where if certain financial or economic conditions can be arranged then a suitable price can be evolved wherein the product can be sold. The markets are well known. I think that both the refinery proposals that were submitted have good feasible business plans, the markets are known, the rate of growth are know; they are quite predictable. The two chemical companies - the two petrochemical projects are similarly unpredictable. And I think that we have heard this morning what I would consider a very fair and balanced representation of the uncertainties in developing a petrochemical project.

I would - I think I would paraphrase a couple of the comments that we heard. Dr. Spitz dir ssed at great length the difference between the short term outlook and for chemicals and the long term outlook for chemicals. And I concur completely with the evaluation that it's a cyclical business from the standpoint of supply and demand and currently we are in a state of oversupply but we will not be for many years. So down the road there definitely is and will be for many years to come room in the market for projects that are carefully conceived and patiently executed.

By the same token the problem in putting one of these proposals together was I think identified by one of the other speakers in connection

with the reaction of certain of the parties in Japan. That as long as you sit there with overcapacity you can't sell out for the next two years it's hard to think about what you're going to do five years down the road. And I think that's the fundamental problem that any petrochemical project in the United States or abroad faces in trying to get the thing developed in a limited period of time. So the question of likelihood of implementation or the certainty that Alaska would have an industrial complex based on hydrocarbons in the future is going to be somewhat less if you go the petrochemical route, it would be greater if you go the refinery route. By the same token, the existence of a petrochemical complex of a type that is contemplated definitely offers the opportunity for future growth, growth of satellite industries, growth in demand for the products that are built by the facility and the opportunities to upgrade in the future fuels into additional production of petrochemicals. So I think then one might say that the State's long term interests is to foster a substantial and growing industrial development based on hydrocarbons. Then certainly the petrochemical industry offers a much greater opportunity to do that. Accompanying this greater opportunity is a mugh higher risk of uncertainty that within the time frame we are discussing such an opportunity can be effectively promoted. However, I think the proposals that have been made at this time are well conceived, if aggressively and intelligently executed would maximize the chance - would maximize the chance that this was a difficult undertaking could be accomplished. Thank you.

LeResche: Thank you, Joe. Questions from the Board?

Lyon: Your first report was in January.

Moore: January 3rd. I have a calendar. I missed the football games to come up to that, I remember.

Lyon: I think I recall asking you whether any of these will fly and you said as they are presently constituted, no. You probably didn't say that because you don't say it quite that hard. Is it your opinion now that these can be made to fly?

Moore: I think that I'm having to - part of my answer has to do with what I've heard second hand about the financing report; particularly as it regards Petrofining's. If the Petrofining project did not have any financing problems which I don't know whether it does or not. I feel that project had a high likelihood of flying. I think the Alaska Petroleum is limited primarily by the actions of its own parent company - if the parent company decides that it's a viable business they want to be into then I think the business certainly is there to make it fly. The petrochemical ones they're riskier. In trying to quantify how risky they are I just - it's just a very hard thing to say. You know are the chances 50-50 that it will fly? I guess I would answer I don't think they're better than 50-50. But I don't know if I could be more precise than that.

But I think there is very definitely a risk in either of the petrochemical ventures; but in the timeframe we're talking about, and I take into account particularly the Alpetco timeframe, time line, that by 18 months they would have 70 percent of their output sold, and that it could be sold under terms that will ultimately permit the financing to take place; that's a tough job.

Lyon: You're asking someone in 1979 to be wise about how

things will be in 1983 or 1984.

Moore: Uh huh.

Lyon: It's hard to do.

Moore: Well and it's a competitive business I think the approach they are taking minimizes the effect of competition. They are now proposing, perhaps they were earlier and I did not understand their plan as such but the notion of taking in joint ventures, the notion of positioning themselves as a supplier to non-competitive interests I think is a vital tactic in strategy in developing a project of this sort. It was first articulated to this group by Alaska Oil & Chemical and has now been more specifically articulated also by Alpetco, and I certainly agree that that's the way to go. And I think that sort of thing is do-able. You know - there's a certain amount of luck and a lot of hard work and a lot of astute negotiation I think. There certainly are - there certainly are ample - well ample, there are a few examples of similar projects having been developed elsewhere. I mean there's not a lot of them - but there are some. .... (unclear)

Moore: Are there other questions?

Warwick: Joe, if you were involved in say a not one of these proposals but say there was a fifth proposal and you were retained as a consultant to the firms bidding for the royalty oil for this Board what would you recommend as far as implementation and acknowledging that there is a high degree of interest on the part of the Board in petrochemicals. How would you ... what would you recommend to the people who retained you as far as a method of proceedings. Not necessarily telling the Board what it wants to hear but implementing the project.

Moore: In terms of a business plan?

Warwick: Yes.

Moore: Well, I think I would follow the same general strategy that has been outlined in the two proposals at this time. That is the notion of developing a core facility which can produce products for next line consumers if you will, or the producer of petrochemicals up the chain from the basic petrochemical raw materials who themselves do not have assured sources of supply. In terms of basic strategical issues in the petrochemical industry the question the future question of hydrocarbons supply has been predominant for many years. By many years, 10 years; perhaps even longer than that. And on one hand you have the oil companies who let's say traditionally were not in the petrochemical business but certainly have gotten heavily into that business in recent years. Then you have the traditional petrochemical manufacturers who traditionally have not had a supply of hydrocarbons. They have bought hydrocarbons on a market which had an excess supply. And as that excess supply disappeared then the long term strategy of the company is how it stays in business has gotten very much involved with where does it get it's future supply from. Now the thing that a petrochemical project in Alaska can offer as has been stated very concisely from the people from Alpetco, is an assured source of supply. So the problem that you have in development or in promoting such a project is to offer that secured source of supply to someone to whom that is an advantage. Now that means you don't go out to the major oil companies and say won't you buy some of our ethylene, probably. They certainly are trying to protect their own share of market. But I think the general plans that emphasizes

the control of the feedstock and goes to companies who are insecure in a source of feedstock is the basic strategy you deal with.

Warwick: I'm not sure what you are saying - it appears what you're saying is initially you commit yourself to an oil products refinery and then at some future date, maybe after the refinery is in production, that you add on petrochemicals. Is that -

Moore: No, I didn't mean to say that. I think that the basic industrial process of producing petrochemicals does lend itself to a gradual conversion, if you will, from the utilization of the most of that material - fuels to utilization of most or at least a high percentage of that material to petrochemicals. And that can be done over a period of time as markets develop.

Warwick: Historically what percentage of refineries do convert to petrochemicals? Is that -- transition?

Moore: Oh, I think most refinery capacity in the United States has been most of the barrels of oil that are refined in the United States do have some petrochemical byproducts produced by most I mean 80 or 90 percent. There may be very many small refineries that don't produce any petrochemicals but in terms of the quantity of crude oil that is processed in the United States most of it has some petrochemicals extracted from it. Now in terms of percent of crude oil which is converted in petrochemicals I think in the U.S. right now it is about 4 percent. But - and this is because the bulk of petrochemicals in the U.S. have not been made from crude oil in the past. They have been made from ethane, natural gas or natural gas liquids which was how the petrochemical industry in the U.S. basically started - or at least that's how

the ethylene business started. Most refiners produce what are called aromatics. You've heard the term several times today - benzine, tylene, zylene or BTX - that's a one word term in refineries and U.S. refineries started in that business right after World War II and most of them are in it.

Warwick: It would appear to me and I don't have anything to base this on should we get initially an oil products refinery that would be somewhat difficult to add on the petrochemicals if for no other reason because of the financing agreement the company would have more or less long term commitment for oil products rather than petrochemicals and the incentives or the ability to convert to petrochemical might be somewhat difficult.

Moore: If you couldn't get any more crude oil to add additional feedstock to your facility and if in fact all of your output was tied up in long term contracts then I would agree. It would be difficult. You have less flexibility here in these proposals than you would have if you had a major oil company that was established in the market and was simply supplying to the market or on short-term contracts where they had more flexibility in their planning process. I think here the financing requirements do impose certain rigidity on that problem.

Warwick: What additional quantities of crude would we be talking about?

Moore: Well, I think a significant petrochemical production facility can require not much less than 100,000 barrels a day of oil. If you are going to make ethylene in a world scale unit as we say here - roughly a billion pounds per year of ethylene this requires something in

the range of 55 to 60 thousand barrels a day of liquid hydrocarbon. And some of the hydrocarbon out of the crude oil is not suitable for an ethylene unit so to make 60 thousand barrels a day available let's say you'd probably have to run at least 80 thousand barrels. So perhaps that represents the minimum throughput for facility that is feeding one - primarily feeding one world scale ethylene unit.

Warwick: Let me phrase the question a little differently. Suppose you have a hundred thousand barrel a day - no let's make it 150,000 barrel a day oil products refinery - what - how much additional crude would be necessary in order to add on petrochemicals?

Moore: Given your premise that you had all the output tied up in long term contracts? or most of it?

Warwick: Yes.

Moore: Well, the amount that you would not have tied up in long term contracts probably if I excluded the Alaskan, the in-state use of fuels from that, there might be only 5 to 10 percent oh..I think one proposal said at one point said they would like to have 20 percent of their products available for spot fills in the market. But we might say in the order of ten percent of the oil output might not be readily tied up in long term contracts so if that ten percent represented 15,000 barrels a day and we needed a minimum of 80,000 barrels a day then you need another 60,000 barrels a day or so of crude throughput to add a major petrochemical facility on top of the the existing refinery that couldn't get out a long term contract. Have a tortured answer to a kind of complicated question.

LeResche: Sterling?

Gallagher: ...five years we see that conspicuous lack of new refineries being built, also (unclear) take place in America.

Moore: If you look at long term projections for petroleum products we see that there is we would expect that there will be continuing growth in the demand for heating lets say fuels as opposed to gasoline. We generally pretty well think that for sure that the present regulations that have been enacted by Congress on automobile - the future efficiency of future automobiles - will cause the gasoline demand to plateau and then to recede. So we think that the complicated part of the refinery, which is that part required to produce gasoline, both the complicated and expensive part, we probably don't need any more of that in the United States except to replace what rusts or has fallen down. We do need more fuel oils for industrial use, power generation, and for home heating. Now those oils in the United States - those oils have to be low sulfur. If we're going to process high sulfur crude oil in the United States which tends to be what's available to us as far as extra supply is concerned, it's very expensive to take the sulfur out of that oil in the United States because we have to make hydrogen and generally our raw material for making hydrogen is expensive. If you look at the alternative of doing this overseas they have ways of making hydrogen that are much cheaper than we can do. For example, in Venezuela, there are gas resources which do not have markets that can be converted into inexpensive hydrogens but - so they can produce low sulfur fuel oil less expensively than we can produce it. So if you look where the increment of growth will occur in the United States it is very susceptible to being replaced by imported product. Gasoline we really can't import

because we don't need any gasoline. Fuel oils we can import and probably we will import most of our future demands for growth in that area.

Gallagher: One of the things I was trying to get at is do you think that current price differential between sweet and sour crudes will widen or become more to reflect the capital cost of installing a sour crude refinery or will it continue not to be reflected.

Moore: If there is no change in the relative availabilities of those crudes then perhaps right now the sour crude - right now the posted price between the sour crude and the sweet crude cannot hold up in the market really. Because the posted price represents more of the quality differential than the refiner sees. I think in the future the refiner will be more taxed to take sulfur out and so I think we would see the price spread continuing to widen unless there were major discoveries of sweet crudes which just would dilute the problem throughout the part of the world that is concerned about sulfur crude oil. But if we take the present supply as being representative of future suppliers the present ratio supply then I would say that the spread would tend to widen. Well let's say the present posted price would tend to return to its actual posting.

Gallagher: So if you feel that a sour crude refinery the chance is the economics will improve in the future/better.

Moore: If I build a sour crude refinery the change of economics will improve--- Oh yes. Right. Right. Yes. Right. Yep, if you wouldn't want to build a sweet crude refinery today unless you put it in Indonesia or somewhere. Then I guess there is some question you want to do that.

LeResche: Don?

Tripplehorn: When we finally end our discussion of an oil disposal problem. You know we're going to face the gas issue and specifically the possible use of gas liquids - is there any incompatibility between a proposal to build a oil based refinery and let's say a possible very large petrochemicals complex with a gas or gas liquids feedstock?

Moore: Okay. The question is there is an incompatibility between an oil refinery...

Triplehorn: Oh, I'm sorry the petrochemical complex based on oil feedstock .. could we, for example, we sign a contract involving development of a petrochemical complex and then also foster the development of another large one based on gas liquids and would that make the previous one uneconomical. As I understand it gas liquids is the preferred feedstock.

Moore: At the right price it is. Don, I think there is an element of time if for example you were to award a contract to one of the petrochemical project proposers here and then six months from now award a - discover that the gas liquids will be available at a suitable price and you awarded a contract to a second group they would out getting in each other's way. I think they would certainly tend to confuse the market and each project would suffer because of the presence of the other.

Triplehorn: But that would hinge on future decisions - at the price.

Moore: Right now we can't say anything about how likely it is that gas liquids or gas would be available at an appropriate price to

foster petrochemical development.

LeResche: Joe, how about the possibility that working together with petrochemical/oil refinery large customer for the ethylene plant. That's one answer I've been given.

Moore: I guess the Alpetco people in essence addressed - Peter Spitz in essence addressed that question. I think in his discussion - he said that they might very well be a customer for the off - the product of an ethylene plant built elsewhere. And if it came along at a time when they were ready to expand their production that would certainly be a business decision that might be a viable business decision for them. It's a matter of timing, I think, more than anything. If an oil based petrochemical plant is in operation and it has a market, it has contracts then the general rate of inflation, if it's not changed, will make all future plants more costly in terms of the cost of their products simply because the capital cost per unit of throughput or unit of product inflates. These petrochemical plants, a high portion of their total costs are capital costs. So if that compenent is escalating then a plant that is built is already in existence already has some built in price protection from plants that would come in at a later date.

Triplehorn: I'm lost it - You ranked these issues. I wonder if you could also rank the obstacles that are to be overcome. I've heard a lot of cost of doing business in Alaska perhaps the geographic location, the variety of things - I don't have a very good feeling for the relative size of the different obstacles - what do you view as the most serious obstacle in making an economically viable project.

Moore: Well, let's take the question of an oil refinery first. I think that well no - in fact - let me not make that distinction - let me open the question simply to processing of hydrocarbons for fuels or chemicals. In the long term I think that the ownership of the raw material, the location of the raw material, is a very strong, positive factor. In the short term you are dealing with trying to create a link in a logistics system that's pretty well defined but that link doesn't exist now. There's nobody set up to take products from Alaska. You have customers and suppliers, who have a long standing relationship. For example, I'm a purchaser of polyethylene in California and I buy mine from the XYZ Oil Chemical Company, if you will. Now if I'm going to come in with a new project and get that guy's business I have to give him some incentive to abandon the XYZ Oil Company as a supplier and take me on as a supplier. Now that's a pretty crucial decision because I, as a consumer of polyethylene say, have got a lot of capital tied to my plant. I have customers I have to supply, so before I decide I'm going to let you supply me with polyethylene I want to be darn sure you're going to be as reliable as the XYZ Oil Company. And I think if you go out into the real world in trying to develop a project like these petrochemical projects particularly, or an oil project either, I think that you have a major problem of overcoming the - I don't know whether it's an energy barrier or a natural conservatism, or whatever it is - to create new supplier/customer relationships. You overcome that in various ways. And I think one way that we've talked about overcoming that here is you go to that customer who presently does not control the feedstock which

goes into the productior of his polyethylene.

You say now in place of buying from me why don't you come in with me and you can build your own plant or I'll go in 50/50 with you if you don't want to put up that much money. And together you could integrate backward in your supply chain in effect. In general that's an attractive thought for a businessman. He controls one more element of his business. So I think this is both a problem that you have in developing any of these ventures from a remote geographical area and as a new promotional company and the thing that you have to do to respond to that. You've got to say that I'm going to be a reliable supplier and I'll supply to you at a price that is attractive to you. Of course this is another problem too, that anyone can promote a project and give the product away and the trick that any of these people will have in putting the project together is to build their market at prices that will support the financing. Because ultimately you still have to protect the rate of return that the financial institutions will demand in order to feel that the project is viable. So you have to develop the market in a way that does not lock you into an adverse profit position and you have to overcome the problem of historic supplier/customer relationships and establish credibility in the eye of the customer that you are a preferred supplier. One of the tricks you have of dealing with this is to get him to join in with you because you give him an opportunity to integrate backward that he perhaps he doesn't have otherwise. I'm sure there are many other answers to that question, but - based on a short thought about it...

Triplehorn: ...much more serious than the increased costs of

doing business in Alaska would be ...

Moore: Well the increased cost of doing business gets down to the cost that you can afford to sell a product for. And one reason that given - forgetting all of the variables and just looking at the petrochemical products versus refinery products - generally petrochemicals are more a more profitable business per unit of throughput than a refinery is. And they are cyclical. There are times that they are very profitable and there are times that they're not so profitable but I'm not sure they ever - at least very rarely - get as unprofitable as a refinery is. Refineries are just not very profitable businesses. But, the petrochemical plant or the petrochemical venture if you establish market situations that are stable enough you have more profit margin to reduce if you exchange it for certainty that you actually will be able to supply the product.

For example, I can, if I'm just - if I build a plant without an established market - you know I'm the giant ethylene supplier and in the Gulf Coast in the Houston/Louisiana area we actually have a network of pipelines that supply eythlene. So I can build a plant essentially anywhere on this pipeline and put my ethylene in that pipeline and somebody else will take it off 200 or 300 miles away. So I have a very simple logistics problem. I just simply put just simply (unclear) some ethylene in the pipeline and go out and make my contract and the user is assured of how he will get his supply. He will get it from the same pipe that he's got it from for ten years.

Now here we have a totally different situation in that you don't have an established supply pattern. And that is a problem to

overcome but you do have enough profit margin in the typical petrochemical project that you have a little bit more latitude in what you will accept as a rate of return if you have a certainty that you've got a customer/supply relationship that you can count on long term. And I think that all these people have implied that they do need a very long term commitment on offtaking product. With that long term commitment you then have quite a bit of flexibility on paid price of product because you will have an adequate return to play with, if you will.

LeResche: Sterling?

Gallagher: (unclear)

Moore: Well, you've got the Middle East, for example, well they're much higher. To my knowledge construction costs outside of Iran, for example, probably hasn't even stabilized enough to where you know for sure. I think all the major projects that are presently being constructed in Saudi Arabia are continuing to escalate primarily because there's not the infrastructure there to carry out an industrial development project. It's one of those things that if I had a port I could unload the ship; if I had a warehouse to put the stuff in, if I had a road to get it out of it, if I had a railroad, -- you just don't have anything there. So what has happened that caused construction costs to esclate so very rapidly in those areas is that every turn you take you're bottlenecked for some reason or another. And a lot of money is spent on activities that you don't normally think of associated with the construction. You have to build roads, you're delayed tremendously; you can't get cement unloaded. For example three years ago there was not a single bulk cement plant in Saudi Arabia. I don't know exactly how

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

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

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

LeResche: Don?

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

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

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

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

Triplehorn: Maybe nobody knows that.

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

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

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

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

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

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

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

Moore: Thank you. My pleasure.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Wetzel: I can explain the graph briefly if I may. This is the Van Poolen case (3a) modified by Bob LeResche's letter of February 1st imply one year (unclear) the problems that Station 8 (unclear). What we have shown on here on the left hand side is a producing rate which does go to a million and a half barrels a day which exceeds present pipeline capacity. We recognize but nevertheless that is the forecast. We've also shown down here the royalty oil in blue and 85% of the oil is in the orange. For your information we have shown start up at the end of 1982. According to the figures about 40%, another 40% of Prudhoe Bay oil will be gone at the time a plant could start up. This caused us some concern.

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

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

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

this.

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

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

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

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

LeResche: ny questions from the Board?

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

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

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

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

Pignalberi: That's correct.

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

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

Wetzel: That's correct.

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

LeResche: The Board has other questions. Don?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LeResche: Dick?

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

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

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

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

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

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

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

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

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

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

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

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

LeResche: Anymore questions?

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

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

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

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

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

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

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

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

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

opportunity to speak to it.

LeResche: Any more questions? Thank you very much.

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

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

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

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

(Unclear)

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

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

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

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

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

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

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

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

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

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

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

LeResche: Any questions?

Hartig: Thank you.

LeResche: How many people from the general public, unassociated

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

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

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

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

children.

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

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

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

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

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

Lyon: So move.

Triplehorn: Second.

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

Alaska State Legislature

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TRANSCRIPT OF TESTIMONY OF

ROBERT E. LeRESCHE

March 14, 1978

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

Committee:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

UNIDENTIFIED SPEAKER:

Will you speak a little louder, Commissioner?

COMMISSIONER LERESCHE:

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

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

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

that alternative.

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

Isn't that a Catch-22 though Commissioner?

COMMISSIONER LERESCHE:

No.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

I don't follow that,Bill?

CHAIRMAN MILES:

Well I don't either.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Go ahead, we'll get back to that.

COMMISSIONER LERESCHE:

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

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

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

SENATOR SUMNER:

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

COMMISSIONER LERESCHE:

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

SENATOR SUMNER:

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

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

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

SENATOR SUMNER:

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

MR. BONESS:

No, definitely not.

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SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

Lease sales? I don't see any connection.

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

Under 2.4, yes.

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

There's an express exemption for Tesoro.

SENATOR COLLETTA:

(Indisc. - simultaneous speech).

COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

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

COMMISSIONER LERESCHE:

No.

SENATOR COLLETTA:

2.4 is inclusive of all state interests in production?

COMMISSIONER LERESCHE:

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

SENATOR COLLETTA:

Thank you.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yes.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

No.

CHAIRMAN MILES:

Why not?

COMMISSIONER LERESCHE:

Didn't feel any need to.

CHAIRMAN MILES:

Did you review royalty oil contracts from other states?

COMMISSIONER LERESCHE:

I assume that the attorneys did.

CHAIRMAN MILES

Which ones?

MR. BONESS:

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

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESC[illegible]

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

This is above the weighted average price.

CHAIRMAN MILES:

How much?

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Well, okay.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

But he can't put a price on it?

COMMISSIONER LERESCHE:

No, because it's a probability judgment.

CHAIRMAN MILES:

Chat do you want to follow on that?

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

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

MR. CHATTERTON:

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

CHAIRMAN MILES:

Go ahead.

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. CHATTERTON:

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

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

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

COMMISSIONER LERESCHE:

That's correct.

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

No. Okay.

MR. PARR:

No question about it.

COMMISSIONER LERESCHE:

Okay, I guess I understand that.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yeah, they approved the contract.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

They made five or six specific findings.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

No other oil?

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

We have written approval of the Board.

CHAIRMAN MILES:

Is that right?

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

They speak to this contract.

CHAIRMAN MILES:

Which one?

COMMISSIONER LERESCHE:

This one.

CHAIRMAN MILES:

Which resolution?

COMMISSIONER LERESCHE:

All of them.

CHAIRMAN MILES

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

COMMISSIONER LERESCHE:

Okay.

CHAIRMAN MILES:

We've got a legal opinion that says that.

MR. BONESS:

We haven't had the benefit of that opinion.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

Yeah. I just got it yesterday, myself.

CHAIRMAN MILES:

Joe.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

Using royalty oil, yes.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

Not a veto, a chance to meet the price.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

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

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

That's right.

MR. MC KINNON:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

(Indisc.)

MR. PARR:

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

COMMISSIONER LERESCHE:

Yeah.

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

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

COMMISSIONER LERESCHE:

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

MR.PARR:

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

COMMISSIONER LERESCHE:

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

MR. PARR:

Thank you.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

So ALPETCO gets 150,000 barrels?

COMMISSIONER LERESCHE:

If we have it.

CHAIRMAN MILES:

Yeah.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

That's right.

CHAIRMAN MILES:

Right. Okay.

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Metaphysical.

CHAIRMAN MILES:

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

the fox right in the chicken coop.

SENATOR SUMNER:

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

CHAIRMAN MILES:

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

SENATOR SUMNER:

But this wouldn't do it here?

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

(Indisc.)

MR. CHATTERTON:

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

UNIDENTIFIED SPEAKER:

Right.

MR. CHATTERTON:

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

MR. BONESS:

May I interrupt just for a second?

MR. CHATTERTON:

Yes.

MR. BONESS:

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

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

MR. CHATTERTON

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

MR. BONESS:

Okay.

MR. CHATTERTON:

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

MR. BONESS:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

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

MR. CHATTERTON:

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

MR. BONESS:

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

MR. CHATTERTON:

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

MR. BONESS:

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

MR. CHATTERTON:

Well let me interrupt, if I may --

MR. BONESS:

Okay.

MR. CHATTERTON:

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

MR. BONESS:

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

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

MR. CHATTERTON:

We have some unknowns then?

MR. BONESS:

That's right. There are some unknowns.

MR. CHATTERTON:

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

COMMISSIONER LERESCHE:

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

MR. BONESS:

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

MR. CHATTERTON:

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

UNIDENTIFIED SPEAKER:

He confused me.

COMMISSIONER LERESCHE:

He left out 2/3's of it.

CHAIRMAN MILES:

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

(Off Record)

(On Record)

CHAIRMAN MILES:

Questions.

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

MR. HONIG:

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

CHAIRMAN MILES:

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

MR. HONIG:

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

CHAIRMAN MILES:

Might we get a copy of those expenditures?

MR. HONIG:

Yes, I'm sure.

COMMISSIONER LERESCHE:

They just want to write off Henry. (Laughter)

MR. HONIG:

We've already done that.

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

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

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

COMMISSIONER LERESCHE:

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

CHAIRMAN MILES:

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

COMMISSIONER LERESCHE:

Yeah.

CHAIRMAN MILES:

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

SENATOR SUMNER:

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

CHAIRMAN MILES:

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

MR. BONESS:

Okay, thank you very much Mr. Chairman.

COMMISSIONER LERESCHE:

Thank you, Mr. Chairman.

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

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TRANSCRIPT OF TESTIMONY OF

MILTON LIPTON

March 15, 1978

BEFORE THE SPECIAL COMMITTEE ON ROYALTY OIL AND GAS

Committee:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

back.

MR. LIPTON:

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

You just come on up.

MR. LIPTON:

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

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

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

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

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

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

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

petro-chemical capacity in the Middle East itself.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CHAIRMAN MILES:

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

MR. CHATTERTON:

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

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

MR. LIPTON:

There is a risk. There surely is a risk.

MR. CHATTERTON:

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

MR. LIPTON:

Well, you put your questions very, very directly, and it's awfully hard for me to equivocate when you put them that way, and I can't. Yes, I think you have a right to take the risk because you always take the risk. You take the risk in every kind of a lease sale. You take a risk when you select the bidding variable for a lease sale. You take a risk when you decide on how you choose among tax alternatives. These are all risks. I guess, unequivocably, I've got to say yes you have a right to take a risk on this, also.

MR. CHATTERTON:

Okay, fine. Fine. Thank you.

MR. PARR:

Mr. Lipton, if I understood you correctly, I think what you saw as the main advantage of this whole contract operation is that you got a breakthrough. You finally find someone who is willing to stick his neck out and go for a petrochemical complex in the West.

MR. LIPTON:

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

MR. PARR:

Okay.

MR. LIPTON:

That's it.

MR. PARR:

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

MR. LIPTON:

For a specific market. For a specific market.

MR. PARR:

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

MR. LIPTON:

Increasingly, yes.

MR. PARR:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

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

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

Absolutely.

CHAIRMAN MILES:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

MR. LIPTON:

For what? I'm sorry.

MR. OSTERBACK:

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

MR. LIPTON:

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

MR. OSTERBACK:

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

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

MR. LIPTON:

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

MR. OSTERBACK:

Thank you, Mr. Chairman.

SENATOR HACKNEY:

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

MR. LIPTON:

With a certain amount of confidence, I will answer, the sky will not fall. Now that I answer the other part of your question, I have more difficulty. But, really, what is now being proposed? The sense of urgency is because of the availability of the oil. If you don't commit it, then whoever wants to put together a project has more and more difficulty of telling his customers and his financiers that the one thing I've got that other people don't have is the short availability. 'Cause the further you postpone it, the less assurance there is of availability, unless, come '79 and an open-lease sale and some successful drilling, and then everything gets turned all around.

But, I would think that a year or two is not going to be tragic for Alaska, except that, in a sense, what you're saying is we are turning our back on what has come to us in good faith, because we are hoping for something more. I would. . . This has to do with the psychological. But, the companies who might otherwise be involved with the ALPETCO group are not going to disappear in a year or two. They are still going to be there for ALPETCO or anybody else, or maybe come in as a party of the first part. I don't know, and I certainly don't hold this out as something of great promise.

I really don't think that . . . It's one set of uncertains against the other. There are risks in this; there are uncertainties if you say no. At least what you've got here is certainly a promise of sincere and major effort. I think that that's about the best that I could. . . There are uncertainties all over the place for them, for the State of Alaska.

CHAIRMAN MILES:

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

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

MR. LIPTON:

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

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

MR. CHATTERTON:

Thank you, Mr. Chairman.

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

MR. LIPTON:

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

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

MR. CHATTERTON:

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

MR. LIPTON:

Of course, of course. Surely, surely.

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

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

MR. LIPTON:

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

MR. CHATTERTON:

Thank you. Thank you, Mr. Chairman.

MR. MCKINNON:

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

MR. LIPTON:

Yes.

MR. MCKINNON:

Another (indisc.)

MR. LIPTON:

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

MR. MCKINNON:

Is that only for a deficiency out of Prudhoe?

MR. LIPTON:

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

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

MR. MCKINNON:

Yes, that's the way I interpret it.

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

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

MR. MCKINNON:

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

MR. LIPTON:

I don't believe it does.

MR. MCKINNON:

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

MR. LIPTON:

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

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

MR. MCKINNON:

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

MR. LIPTON:

Yes.

CHAIRMAN MILES:

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

MR. LIPTON:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

MR. PARR:

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

MR. LIPTON:

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

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

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 Japa se have held it out, that they will pay premiums for securi y 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 exspansible source of crude oil reserves production for the world will be Saudi Arabia.

CHAIRMAN MILES:

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

MR. LIPTON:

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

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

CHAIRMAN MILES:

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

MR. LIPTON:

I'm sorry, I misunderstood you.

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

CHAIRMAN MILES:

Thank you.

MR. CHATTERTON:

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

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. Cha[illegible]n.

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. CHATTERTON:

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

MR. LIPTON:

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

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

UNIDENTIFIED SPEAKER:

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

CHAIRMAN MILES:

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

MR. LIPTON:

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

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?

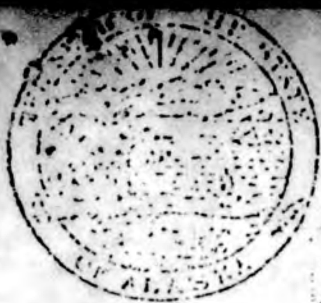
MR. LIPTON:

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

DR. TUSSING:

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

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

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

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

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

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

CHAIRMAN MILES:

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

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 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 puchase price of $7.00 at the well head, plus shipping costs to the West Coast of $.85, plus an ALPETCO margin of $.25, and tax (indisc.) for $5.40, and give a $13.50 sales price on the West Coast. Well now they're starting with different numbers - and I won't quarrel with those, because they are based on other assumptions as to what the actual tax tariff will be and what the net back will be. But the problem here is ALPETCO takes oil that costs the $11.79 at Valdez, that is, well head price plus tax tariff, and there is no way that it can sell it on the Gulf Coast. ALPETCO gets 150,000 barrels, 140,000 barrels, of oil for $11.79. They lose money unless they can sell it for $10.72 plus transportation to the Gulf Coast, which is $3.00. So there is no way that ALPETCO can consider marketing on the Gulf Coast. ALPETCO, if it takes this oil, has to go into the West Coast. What can ALPETCO afford to do? ALPETCO says that it is looking for a two percent margin, so that brings its price at Valdez to $12.03. And, in that case, they can undersell the West Coast price by $.60. In other words, the value of North Slope crude oil on the West Coast as set by what the other producers are charging is $12.63. ALPETCO is getting its oil and is willing to sell oil for $12.60. I mean $12.03.

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

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 pri ship it to the Gulf Coast, and take a lower price if the ould 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 Calfornia price is determined by OPEC is - what is the transportation cost beyond California to the next market, which is the Gulf Coast, or to Japan? That is, it's the OPEC price in a third market that then begins to determine the Prudhoe price.

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

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

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 rachet, because the equilibrium price - that is - the normal situation and the absence of some sort of anti-competitive behavior, is the same for all destinations at Valdez. And that the big three would have to collude, and they'd probably have to get the California independents on board. They would have to engage in per se violations of the anti-trust laws to re-establish the differential price structure I think that once this differential price structure is knocked down by competition it would take a positive intervention - anti-competitive intervention - for the market to restore. So....

UNIDENTIFIED SPEAKER:

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

DR. TUSSING:

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

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

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' 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 elses. So you're not taking advantage.

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

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

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 Y, STATE CAPI
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:	Representatives:
Chairman, Mike Colletta	Chairman Bill Miles
Pat Rodey	Charley Parr
Bill Sumner	Chat Chatterton
John Sackett	Joe McKinnon
Kay Poland	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 sayingis 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 billion 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 exluded 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 monitary 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 elses 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 ligatory 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 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:

Maý 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 g eat 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 represe 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 hypothicating.

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 expe... 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

that you will have no lien on that oil -- again it's not all the oil, it's just for these four carriers who have lien prohibitions in their tariffs -- while it goes down the line there will be no lien on it but there's a prohibition against our putting any other liens on it and the lien will be attached once it hits Valdez.

CHAIRMAN MILES:

I wish I knew something about lien laws, I guess I'd understand it, but it seems to me reading 12.1 that we have no security until it gets to Valdez and then we can't slap a lien on the products if we have to after because it says no liens will attach to any oil or products produced therefrom, so we don't have -- will you run that through again.

MR. ROGERS:

Yeah --

CHAIRMAN MILES:

(Indisc.--simultaneous speech) gets to the facility, the facility processes it and then we can't slap a lien on it once it goes out.

MR. ROGERS:

Yes, you can. We can't. We c[illegible] put any other lien on it. The lien of the seller automatically re attaches at Valdez. All the oil coming out of the TAPS line will have a seller's lien on it 100%.

CHAIRMAN MILES:

Where does it say that?

MR. ROGERS:

Well at the beginning of 12.1 it says all oil will have a security interest on it from the point of delivery. Then it says notwithstanding the provisions of the above which say the oil lien will attach at pump station number 1, seller agrees that the security interest shall not attach at the time of delivery but instead it will attach when it arrives at Valdez. As to any oil shipped, not all of the oil, but just to any oil shipped under the tariff pertaining to the TAPS, which contains a prohibition against -- that's the whole basic problem. The tariff says if I tender oil that has a lien on it, the carrier can say, we don't want it.

Some of those carriers are also other producers that have oil that they'd like to ship. We don't want to be in a position where they can reject our oil. And that was one of our biggest arguments for accepting the delivery at Valdez and not at pump station number 1.

CHAIRMAN MILES:

I don't think I (indisc.) Let's go on.

MR. ROGERS:

Let me summarize perhaps for you -- where you end up. The state will always have a lien on all of the oil, all of the crude oil, until it's paid for except in one excepted instance and that's as to those -- the pipeline is owned by a number of people in undivided interests, so you've got more than one tariff. If you have a bunch of tariffs and three or four of those say you can't ship any oil down our line if it has another persons lien on it because that might interfere with our own carrier lien. So we have a right to reject that oil. One tariff says it prohibits any oil that goes in the pipeline that has a lien on it. So we just provided that instead of the lien attaching at pump station number 1 at the top, as to those four, the lien will not attach here but will attach at the bottom of the line. And it also says ALPETCO, you can't put any lien on that oil while it's going down the line or grant a lien on it to any other third party without our permission.

CHAIRMAN MILES:

Then doesn't it further say --

MR. ROGERS:

Yeah, just to that portion of the oil.

CHAIRMAN MILES:

What happens after it goes out?

MR. ROGERS:

The lien re-attaches as it goes off and the lien continues at that point as long as it is not paid for, and to the products that are produced from any, and any accounts receivable that are created by the sale of it.

UNIDENTIFIED PERSON:

(Indisc.)

CHAIRMAN MILES:

So then, where am I, I'm at page 37 about the 6th or 7th line, and the language says no lien shall attach to any oil or products produced therefrom.

MR. ROGERS:

Okay, now that is another exception. We have the right to say over in that storage barrel is a $100,000 worth of crude oil. Here's $100,000, release your lien on that oil and the state is obligated to do so. The state doesn't care because it would rather have the cash payment then it would the crude oil.

CHAIRMAN MILES:

It certainly doesn't seem to say that to me but I won't belabor the point.

MR. ROGERS:

If it makes you feel any better, both of the lawyers working on it will be suprised if this doesn't fox even the best commercial banker. The whole paragraph 12.1 is highly complicated. It has been revised and had the insertion of about 10 lines into it and it is one of the most difficult paragraphs to understand. We have run it over enough that it does what the state and ALPETCO want it to do but it is not easy to understand.

CHAIRMAN MILES:

Thank you. Any questions?

MR. ROGERS:

Do you have a question for me?

MR. PRATT:

I'm worried about Mr. Miles' last question, are you of the opinion that somehow we get the oil into the refinery or the petrochemical complex and thereafter you have no lien on anything?

CHAIRMAN MILES:

Yes, yes, that's my concern and I have to perhaps have another lawyer translate (indisc.)

MR. ROGERS:

It'll take a translation. There are only two instances in which a lien will not exist. From pump station number 1 down to the full

point of payor. Those two instances are this weird situations along the pipeline as to those carriers that have a lien prohibition. And number 2, as to any time that one of the banks -- the specific reason for the creation of little "ii" in the middle of page 37, was at the instance of our lender. He said he wanted the ability to lend us say 100 million dollars and get some security. And if he was lending a 100 million dollars on a hundred million dollars of our accounts receivable, he wanted to have those accounts receivable available for security for himself. So this just provides that it's just a switch and the state ends up with money rather than security which is good for the state. We have the right to have our bank come in and buy $100,000 worth of receivables by paying the state $100,000 in cash.

MR. PRATT:

You have a lien or a security interest on the accounts receivable of the petrochemical complex unless the bank comes in and says, here, here's a 100 grand, now we want that security interest. In which case your security interest on that 100 grand is gone because you've been paid off.

CHAIRMAN MILES:

I just don't read it that way but --

MR. ROGERS:

Perhaps you're forgetting the general --

CHAIRMAN MILES:

I'm not arguing the point.

MR. ROGERS:

Yes, I understand it so go back to the general -- the only way to keep your mind straight as you go through all the exceptions is to keep in mind the general provision at the very beginning which provides for a blanket lien -- blanket security interest to the state on everything. The crude oil, the products, the accounts receivable and the proceeds and then it says well, notwithstanding that, here are two exceptions. And it's the exceptions that are so horribly complex that they've become almost unworkable --

CHAIRMAN MILES:

It's certainly unreadable.

MR. ROGERS:

I plead guilty on that. I can't blame that on some special counsel either.

CHAIRMAN MILES:

Ms. Kallab.

MS. KALLAB:

(Indisc.) Have you made arrangements to correct some non-substantive mistakes that are in the contract? I just wondered if you had made arrangements with the administration?

MR. ROGERS:

Yes, I believe we have.

MS. KALLAB:

Will we be getting corrected copies of the contract then, because they obviously will have to be executed and signed by you as chief counsel?

MR. ROGERS:

Commissioner LeResche will be back in town tomorrow morning and that was one of the questions and reasons I came up here and probably the best thing to do is when the last unexpurgated final, final version is done, we can circulate it with some notation, perhaps a gold star on it, that will indicate that it's the last copy. We were all very rushed and very exhausted when we got to that point and I'm embarrassed that there were so many --

MS. KALLAB:

It's a minor point, but I just wanted to know.

MR. ROGERS:

If you will let me know after we're done, what it is, I'll make sure that it was one of the corrected things.

CHAIRMAN MILES:

Are there further questions? I have a few but it's 9:30 and we've been working hard enough the last 10 days. Thank you very much. We certainly do appreciate your time.

MR. ROGERS:

I'll be here tomorrow if any of you have some more concerns or if you'd like to go over your questions tomorrow, I'd be glad to stop by your office and answer any of your concerns. You just get in touch with Henry. I'm available to come back up or talk to you by telephone if you run into anything after I leave town too.

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