PRICE AND TRANSPORTATION POLICIES FOR NORTH SLOPE CRUDE OIL

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at a hearing of the
Federal Energy Administration

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1. My name is Arlon Tussing and I am a professor of economics with the Institute of Social and Economic Research (ISER) at the University of Alaska. My own background in the subject matter of this proceding includes participation in legislative drafting of the Trans-Alaska Pipeline Authorization Act, the Emergency Petroleum Allocation Act (EPAA) and the Energy Policy and Conservation Act (EPCA), and in staffing U.S. Senate committee and floor deliberations and House-Senate conference committees on these and related bills. I am also the author of the Senate's 1974 study of the Trans-Alaska Pipeline and West Coast Petroleum Supply, which first identified the problem of the so-called West Coast crude oil surplus, and considered its pricing implications.

2. I am appearing here to summarize a study of federal policies affecting the wellhead value of Prudhoe Bay crude oil conducted at ISER under my direction for the Alaska legislature's special subcommittee on oil and gas taxation. In the short time available today, I can offer only a brief summary of our findings and recommendations. Unfortunately, reproduction delays made it impossible to submit the entire study report to you now, but we would be happy to submit it for inclusion in the record of this proceding as soon as it is printed.* The views and recommendations I express here are my own, and not those of any agency of the University or of the state legislature.

*(Write to ISER, 707 A Street, Anchorage 99501 for copy)

3. The report's conclusion is, briefly, that Prudhoe Bay crude oil should be treated as upper tier controlled oil in FEA's allocation program, and not as uncontrolled oil as advocated by the Alaska Department of Revenue and the producing companies. At the same time, however, we urge that the President find that exports or exchanges of crude oil surplus to PAD District V (the West Coast) are in the national interest, and promulgate a liberal policy toward such exports or exchanges under section 28(u) of the Mineral Leasing Act. These two recommendations are offered together, and we do not regard the implementation of either one of them alone as a feasible policy.

4. The producing companies, the State of Alaska and the Nation share a common interest in removing any barrier or disincentive to the full development of the main oil reservoir at Prudhoe Bay, the development and production of the Kuparuk and Lisburne formations, and the added investment in pipeline pumping capacity that is necessary to transport oil from these reserves. At the present time, the companies have suspended all plans for development of the field and the pipeline beyond a capacity of 1.2 million barrels per day, mainly because of uncertainty about markets and transportation facilities beyond the West Coast.

5. The most direct and most feasible way of removing uncertainty about markets for North Slope crude oil is for the

President to find that it is in the national interest to export or exchange any PAD District V crude oil exceeding the amounts that can be used by refineries in the District, and to direct the FEA and the Office of Export Administration to license such exports.

6. Export licenses would be allocated in much the same way as District V import tickets were allocated under the Mandatory Oil Import Program (MOIP). Each month, the Bureau of Mines would project crude oil production, while FEA took nominations of crude oil requirements from refiners. Licenses for the difference between the two totals in District V would be allocated to all producers in proportion to their crude oil production. Flexibility with respect to transportation arrangements and crude oil grades would be assured by allowing producers, refiners and exporters to trade freely in export licenses, and by permitting the licenses to be used for export of high sulfur residual fuel oil as well as crude oil.

7. We are well aware of the history of section 28(u) of the Mineral Leasing Act, which places severe restrictions on exports of crude oil carried through the Trans-Alaska Pipeline, and of the powerful emotional and political reactions that can be generated by proposals to export North Slope oil. Between 1969

and 1973, President Nixon, Secretary Morton, Governors Hickel and Egan and the major producing companies all assured Congress and the Nation that there would be no West Coast oil surplus, that the Trans-Alaska Pipeline was being built solely for the sake of national energy independence, and that exports of North Slope petroleum to Japan were not even being contemplated. Much of Congress and the public were unconvinced; without such assurances together with the export limitations imposed by section 28(u), even the atmosphere of urgency created in 1973 by the Arab embargo might not have convinced Congress to approve a pipeline from Prudhoe Bay to a Pacific Coast port.

8. The Alyeska pipeline was in fact approved and built, and we now face a surplus of crude oil on the West Coast, particularly crude oil of relatively low gravity and high sulfur content. At the same time, no economically and environmentally acceptable system is immediately in sight to transship the surplus beyond District V. In this situation, the natural outlet for this oil is the Far East, and our study has not been able to find any respectable economic or national security argument for requiring it to be sent through the Panama Canal to domestic markets East of the Rockies. Neither President Carter nor Governor Hammond had any part in any earlier compact not to adovcate or approve exports, and if exports are indeed in the

national interest the State and national executive are not morally or politically bound by such promises.

9. Requiring the heavy, high sulfur crude oil that is surplus to PAD District V to be shipped through the Panama Canal to domestic refineries East of the Rockies will cost about $1.00 per barrel more than exporting it to the Far East and importing the same amount of Persian Gulf crude for those refineries. If prices were not controlled, the cost of petroleum products to mid-Western and Eastern consumers would be the same with either alternative, but requiring transshipment through the Canal would depress wellhead prices for all comparable grades of crude oil produced in District V (California or Alaska). For this reason, authorizing exports would neither help nor harm U.S. consumers outside of District V, but it would increase the wellhead prices received by the producing companies and the State of Alaska.

10. As a practical political matter, the political history of this issue makes it utterly unrealistic to expect Congress to tolerate exports of North Slope crude oil, if the only direct beneficiaries from exports are the oil companies and Alaska's treasury. Regardless of the fact that exports or exchanges would increase the Gross National Product and remove a barrier to further development of oil and gas on the North Slope, they would

simply help to confirm existing suspicions that the higher wellhead prices from exports to Japan were the motive all along for building a Trans-Alaska Pipeline to a Pacific Ocean port rather than an overland pipeline to the Midwest. Such an arrangement, moreover, would seem to violate section 410 of the Trans-Alaska Pipeline Act, which provides that the benefits of the oil carried through the pipeline ". . . should be equitably shared, directly or indirectly, by all regions of the country."

11. The heart of our recommendation to FEA, the President and Congress is that the Nation take advantage of the transportation cost savings that result from exporting or exchanging oil that is surplus to District V needs. We suggest, however, that these benefits not redound to the producers and the State of Alaska but be redirected to consumers across the United States through the pricing and allocation system.

12. An upper tier ceiling on the first sale price of North Slope oil will not actually constrain that price, because of the high pipeline tariff. The price at the wellhead will be controlled by FEA nonetheless, through the "entitlements" program established to equalize the refinery cost of lower tier, upper tier and uncontrolled crude oil. Each refiner earns entitlements in proportion to the crude oil he runs. In order to run

a barrel of lower tier oil he must earn or purchase a full entitlement whose value is the difference between the average refiner cost of lower tier oil and the average cost of imports. To run upper tier oil, he must use a fractional entitlement whose value is the difference between the average refiner cost of upper tier oil and the average cost of imports, while entitlements are not required to run uncontrolled imported, stripper well or Elk Hills oil. Thus, the cost to refiners for price-controlled oil is raised, and that for uncontrolled oil is lowered. Our proposal is that refiners and exporters be required to use a fractional entitlement for each barrel of North Slope crude oil, as is presently the case for upper tier controlled oil. This policy would lower the wellhead price of North Slope crude oil below its free market value but, by "sweetening" the nationwide entitlements pot, it would reduce prices to all U.S. consumers.

13. There is considerable uncertainty over the future value of the fractional entitlement for upper tier oil. We have seen estimates for the end of 1977 running from less than one dollar to more than three dollars; our own projections are toward the lower end of this scale. We suggest, however, that a special upper tier entitlement be established for North Slope oil, with a value just about equal to the cost savings that would be realized by exchanging North Slope oil exported to Japan for

Persian Gulf oil imported at the U.S. Gulf. This value, we believe, will be in the vicinity of $1.00 per barrel. Refiners and exporters would both be required to use such an entitlement to acquire North Slope crude oil. In this fashion, the producers and the state would receive just about the same revenue that they would if North Slope oil were treated as uncontrolled oil within the entitlements program, but had to be shipped through the Panama Canal. With authorization of exports and upper tier treatment, however, the GNP would be slightly higher and consumer prices throughout the nation slightly lower than they would otherwise be, and a major obstacle to the expansion of North Slope oil and gas production would be removed.

14. Crude oil exports or exchanges create no security dangers to the United States which compel the construction of a West-to-East transcontinental oil pipeline system, but there is no reason to believe that such arrangements would destroy the economic incentives to build such a system. This is because projections by the sponsors of the four competing projects (Kitimat, Trans-Mountain reversal, Northern Tier and SOHIO-El Paso) and by FEA all show higher netback prices at Valdez for crude oil shipped to Chicago through one of these systems than for oil shipped directly to Japan. _If_ they are economically justified, and _if_ they can obtain the necessary permits, one of them will be built.

15. Our semi-final observation concerns the impact of North Slope oil on the national weighted average first sale price of crude oil, which is regulated by a formula in EPCA. Legislative history requires that the "first sale" price of North Slope crude oil be the wellhead price, which will be considerably lower than the weighted average established in the law. This fact will give FEA considerable flexibility to raise ceilings for other categories of domestic crude oil, and thereby raise all consumer prices for petroleum products. We fear that doing so, however, would nullify the political understanding necessary to the arrangement proposed here, namely that it is consumers throughout the United States rather than oil companies who are to get the price benefits from exports. For this reason, it would be desirable to exclude Prudhoe Bay crude oil from calculation of the national weighted average first sale price, but according to our reading of EPCA, such an exclusion would require new legislation. Accordingly, what is called for in this situation is forebearance by FEA concerning the prices of other categories of domestic oil.

16. Finally, there is a national security dimension of West Coast crude oil supply and demand that does concern us --- the dependence of West Coast refineries on light low sulfur crude that is increasingly available from only one source, Indonesia.

We believe that it is in the national interest to encourage West Coast refiners to build or modify existing refinery capacity to use greater amounts of Alaska and California grade crude oils. To this end, we strongly oppose any use of the allocation system to offset the moderate discounting of those crude oils on the West Coast that would result from normal market behavior in a surplus situation. We do not endorse, therefore, any proposal to treat North Slope crude differently for entitlement purposes depending on its destination.