The challenge of success

For many Koch companies—and for Koch Industries overall—2011 was a record year.

Flint Hills Resources led the way, helped by record results from Pine Bend and a significant increase in South Texas crude oil production that benefited its Corpus Christi refineries.

FHR’s lubricants business also had a record year, and results for the asphalt and chemicals businesses improved significantly.

Koch Pipeline was busy expanding its system, especially in South Texas, where the Eagle Ford Shale play is boosting domestic production and bringing new crude supplies to Corpus Christi.

High grain prices and low natural gas prices led to strong demand and margins, and a record year for Koch Fertilizer. (Natural gas is often the feedstock for fertilizer.)

INVISTA enjoyed its best year ever as a Koch company. This was true despite softening demand which became apparent during the latter part of the year.

Koch Chemical Technology Group had its second-best year ever (on an operating basis), with Optimized Process Designs turning in a record performance.

Exceptions

There were, however, several Koch businesses that struggled in 2011.

FHR’s North Pole refinery was unprofitable for much of the year, hampered by high energy prices and other constraints.

Georgia-Pacific’s gypsum and wood products businesses—both of which rely on new building construction—suffered as the construction slump in the United States continued.

Similarly, INVISTA’s residential flooring business struggled. With new home construction in the U.S. at historic lows, demand for carpet fiber is depressed.

Prolonged drought in the Midwest and wildfires in Texas were serious issues for The Matador Cattle Company.

And results for Koch Supply & Trading and Koch Minerals were nowhere near the record highs seen a few years ago.

It’s important to note that all of Koch’s primary companies were profitable, even if some subsidiaries weren’t. But it would be a mistake to say that 2011 was a year of uniformly smooth sailing.

Warning signs

As more and more economies slip back into recession—especially in the European Union, the world’s largest market—2012 is likely to be much more challenging.

Some of Koch’s biggest businesses have already reported a slowdown in demand from international customers.

In the U.S., the outcome of the November election could have a profound effect on all Koch companies.

Whether that effect will be for better or worse depends on if lawmakers implement policies promoting economic freedom.

And then there is the age-old problem of overcoming success.

Charles Koch, KII’s chairman and CEO, has repeatedly warned about complacency or smugness after achieving record results.

He did so in his 2007 book, *The Science of Success*, and in his very first Founder’s Day video, recorded eight years ago.

“It is all too easy,” Koch said recently, “to assume that things will keep going your way, or that markets will remain strong and your competitive advantages will never erode.

“Even worse is becoming arrogant or thinking you’re smarter than you really are.

“We must never abandon our principle of humility. To think we can ever know it all or afford to ignore change is delusional. It is also dangerous.”

As Charles Koch emphasizes in his editorial on page 12, the best antidote to this problem is a commitment to our MBM® Guiding Principles—beginning with integrity and compliance.

Given last year’s record results, he also emphasizes the need for humility.

“Our goals are unachievable if we let any success we achieve go to our head.”

Charles Koch’s great-great-grandfather, William Ingraham Kip, was the first Episcopal bishop of California. As Bishop Kip liked to stress: “Pride goeth before destruction, and a haughty spirit before a fall.”
I am writing this for a friend of mine, Mr. Edward Manzano Sr., a Korean War veteran who served in the U.S. Army. Although Mr. Manzano was unable to attend the dedication ceremony of the Coastal Bend State Veterans Cemetery on Dec. 7, 2011, he did visit a few days later to witness firsthand the great work done thus far.

After a couple of pictures and a stroll through the Memorial Walk, we stopped for awhile to watch some maintenance workers preparing for a funeral service. Mr. Manzano is in his early 80s and still is a very strong person. I have only seen him with tears in his eyes a couple of times. His recent trip to the new veterans cemetery was one of them.

He wanted me to tell you he is especially proud of Flint Hills Resources for making the land available for this cemetery. Like Mr. Manzano, I am proud to have served in the military, and also proud to work for the company responsible for making this veterans cemetery possible.

My wife and I have already submitted the paperwork to be laid to rest here. Thank you, Flint Hills Resources, for making this happen.

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My dad, Gary Woodman, recently retired after 31 years at Koch – almost as long as I have been alive. He has talked about Koch Industries for as long as I can remember.

I don’t know if any of the 70,000 people you employ have said thank you, but I would like to take this opportunity to do so – especially as we arrive upon Thanksgiving time.

Dad’s salary met all our needs for a family of six, and a Fred C. and Mary R. Koch scholarship helped me to pay my way through college. (I graduated from Wichita State University with a degree in dental hygiene.)

Thank you for supplying my dad with the earnings to make my life a truly wonderful one, full of very happy memories, health, education and a humbled heart.

May you have many more prosperous years at the company I’ve grown up loving.

Beth Duff
Wichita, Kan.

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Discover
Construction is underway on a new spandex plant in Paulínia, Brazil, to be completed by the end of 2012.

Koch Fertilizer opened a new regional headquarters in Montevideo, Uruguay.

John Zink, a Koch Chemical Technology Group company, acquired Hamworthy Combustion. Hamworthy equipment has been installed in more than 100 countries.

A Koch Fertilizer subsidiary acquired J&H Bunn Ltd., one of Britain’s largest (and oldest) independent fertilizer distributors.

Koch Fertilizer donated $10,000 to upgrade the Brandon, Manitoba, airport landing system.

The mayor of Kingston, Ontario, recognized the INVISTA Centre for achieving the prestigious Leadership in Energy and Environmental Design Gold Certification.

Koch Minerals’ terminal in Lyon, France, set a new record for tonnage transferred.

INVISTA launched its global engineering polymers brand in Germany.
· Following an expansion and several capital investments, KS&T’s Rotterdam refinery in the Netherlands achieved a record year for productivity, despite a challenging market for European refineries in general.

· Following an expansion and several capital investments, Koch Industries donated a total of $1 million to the American Red Cross and Salvation Army in support of disaster relief in Japan following a massive earthquake and tsunami in March that left almost 20,000 dead or homeless.

· In addition, Georgia-Pacific donated paper products, tableware and other relief aids via Convoy of Hope and Feed the Children.

· INVISTA’s venture plant in Tuas, Singapore, received INVISTA STAR certification for exceptional health and safety performance. This designation is modeled after OSHA’s VPP program in the U.S.

· Koch Industries donated a total of $1 million to the American Red Cross and Salvation Army in support of disaster relief in Japan following a massive earthquake and tsunami in March that left almost 20,000 dead or homeless.

· A John Zink flare tip, installed at the Samsung Total Daesung plant 21 years ago, was retired and placed in a special exhibit outside the plant. It was replaced by a new, state-of-the-art John Zink XP flare tip.

· INVISTA opened its expanded Foshan spandex venture site in April and is moving forward with plans for a state-of-the-art nylon 6,6 plant in Shanghai.

· An important MBM® video (filmed at GP-Green Bay) was translated and shared with INVISTA employees in China.

· INVISTA’s venture plant in Tuas, Singapore, received INVISTA STAR certification for exceptional health and safety performance. This designation is modeled after OSHA’s VPP program in the U.S.

· INVISTA partnered with Canterbury of New Zealand to develop state-of-the-art jerseys for the 2011 Rugby World Cup winners.

· Koch Fertilizer added two additional terminals in Brisbane and Adelaide. Together with its existing Geelong location, the company can now service most of the Eastern Australia market.

· A John Zink flare tip, installed at the Samsung Total Daesung plant 21 years ago, was retired and placed in a special exhibit outside the plant. It was replaced by a new, state-of-the-art John Zink XP flare tip.
JANUARY
6 Flint Hills Resources donates $50,000 to Fiesta De Los Niños in Corpus Christi, Texas. FHR has sponsored the event benefiting Driscoll Children’s Hospital for 19 years.

14 Three FHR fuel terminals in Wisconsin celebrate earning VPP Star status.

17 Martin Luther King Jr. Day: Georgia-Pacific donates to hundreds of needy students as part of its Schoolbox Supplies campaign.

FEBRUARY
15 John Zink acquires U.K.-based Hamworthy Combustion.

17 FHR acquires a wharf and pier for expanding its terminal operations in Corpus Christi.

17 FHR acquires ethanol plants in Fairbank and Iowa Falls, Iowa.

23 The price of crude oil hits $100 per barrel for the first time since 2008.

27 Wildfires in West Texas burn 25,000 acres of the historic Matador Ranch.

MARCH

1 An op-ed by Charles Koch is published in the Wall Street Journal.

4 David Koch attends the MIT ribbon-cutting of an integrative cancer research center named in his honor.

11 The biggest earthquake in Japan’s recorded history leaves more than 20,000 dead or missing, triggers a 30-ft. tsunami and severely damages a series of nuclear reactors.

11 A Koch Fertilizer subsidiary acquires J&H Bunn Ltd., one of Britain’s largest independent fertilizer distributors.
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Koch Pipeline Company employees set a company safety record: 10 years (7 million work-hours) without a lost-time incident.

Koch Fertilizer acquires Nitamin® and Nitamin Nfusion® slow-release fertilizers from Georgia-Pacific Chemicals.

Silver sells at a record $50 per ounce, up 81 percent in three months. (Prices dropped 25 percent the following week.)

Osama Bin Laden is killed in Abbottabad, Pakistan.

INVISTA announces a $100 million expansion at its Paulínia, Brazil, spandex facility.

The deadliest tornado in U.S. history kills 160 in Joplin, Mo.

Koch Industries is given the Defender of Justice Leadership Award by the National Association of Criminal Defense Lawyers.

GP’s new, stronger, Brawny® paper towels hit store shelves.

Koch Pipeline’s Bethany, Mo., station earns VPP Star status.

GP participates in an airlift of relief supplies to Joplin, Mo., and other tornado-ravaged communities across the southern U.S.

INVISTA’s spandex facility in Paulínia, Brazil, celebrates its 37th year without a lost-time injury (the longest streak of any Koch manufacturing facility).
Koch Pipeline activates a crude oil pipeline segment in San Patricio County, Texas, to serve Eagle Ford producers.

INVISTA sets a goal of reducing its overall energy intensity 20 percent by 2020.

Koch Pipeline and NuStar Logistics reactivate a 30,000 barrel-per-day pipeline serving Eagle Ford producers.

GP announces a four-year, nationwide agreement with the United Steelworkers.

Matador Ranch receives the top regional environmental stewardship award from the National Cattlemen’s Beef Association.

Standard & Poor's downgrades the credit rating of the United States from AAA to AA+.

Charles Koch’s Founder’s Day message, recorded at GP headquarters in Atlanta, is distributed worldwide.

After an upgrade from Moody’s, Georgia-Pacific is rated investment grade by all major ratings agencies.

A Koch Fertilizer subsidiary acquires Agrotaín International, the world’s largest producer of controlled-release fertilizers.
OCTOBER

31 New domestic crude oil production and increased transportation options allow FHR’s Corpus Christi refineries to reduce foreign oil refining by more than half.

31 UNESCO estimates the world’s population has reached 7 billion.

NOVEMBER

10 Ford Motor Co. wins a top prize for its fuel-saving plastic dashboard, made from a special polypropylene supplied by FHR.

11 GP announces an agreement to sell its consumer products businesses in Europe, the Middle East and Africa.

18 Reiss Remediation changes its name to Koch Remediation & Environmental Services.

19 Dedication of the Koch Family Sculpture Garden at the Wichita Center for the Arts.

30 FHR receives approval to buy a Nebraska biodiesel plant.

DECEMBER

1 Koch Pipeline’s Helena, Texas, terminal opens.

7 Dedication of a 55-acre veterans cemetery in Corpus Christi, Texas. The land, worth $1.2 million, was donated by FHR.

31 Koch companies earned 121 environmental, safety, community stewardship, innovation and customer service awards in 2011, and a total of 444 awards since January 2009.
Unequal playing fields

Although the word “subsidy” is not in the United States Constitution, the federal budget is loaded with subsidy programs – more than 2,000 of them at last count. Subsidies are also a major focus of the European Union, especially for agriculture. Out of the €57 billion the EU spent on agricultural development in 2010, direct subsidies accounted for €39 billion.

Subsidies can also involve rebates and loans at below-market rates. Examples of this in the U.S. have included student loans, home loans, the 2009 “cash for clunkers” program and homeowner tax credits for installing solar panels.

To an economist, a subsidy is something that distorts the market price of goods or services to the benefit of a special interest. Subsidies typically guarantee a profit to the recipient.

The sheer number of federal subsidies always seems to be increasing. In fact, the number of U.S. federal subsidy programs has more than doubled since 1980. This has been true regardless of which political party was in the White House or had the majority in the U.S. Congress.

The only notable exception to this trend was during the Reagan administration.

Doing without

Eliminating subsidies can be painful in the short run, but is almost always beneficial in the long run. However, reducing or taking away a subsidy is seldom popular and can even be dangerous.

“Rice riots” erupted in Liberia when the government’s rice subsidy changed and prices rose almost 20 percent. At least 40 rioters were killed and $40 million in damage done to private property.

More recently, the withdrawal of several subsidies in Europe has also provoked violent responses.

Last year, the cash-strapped British government decided to repeal a 1998 subsidy program that capped student tuition payments at £1,000 per year and allowed at least one-third of university students to pay no tuition at all.

When the change was announced, tens of thousands of students rioted, destroying or vandalizing landmarks and attacking a royal convoy.

Rioters began firebombing Athens, Greece, last October after the government announced new austerity proposals that included reductions in subsidies.

Small change

Forty-five cents may sound like pocket change, but paying that much for every gallon of ethanol produced in the U.S. added up to more than $6 billion in subsidy payments to the corn ethanol industry last year.

In Iowa, the epicenter of ethanol and biodiesel production, more than half of all state aid handed out since 2003 has gone to biofuel companies.

For decades, traditional fossil fuel production, nuclear energy plants and a wide variety of solar and wind energy projects have been subsidized with billions of taxpayer dollars. But much of that economic landscape is now changing.

Last October, the Department of Energy’s loan guarantee program for solar companies expired (although certain tax credits remain). Less than two months later, Congress allowed the Volumetric Ethanol Excise Tax Credit to expire.

Brad Razook, president of Flint Hills Resources, applauds those developments.

“Even though we own several ethanol plants, we believe allowing the ethanol subsidy to expire was a step in the right direction,” Razook said.

“We’re confident that our renewables businesses can compete in any market environment, subsidized or not, and that our base optimization and innovation efforts will continue to create long-term value in the marketplace.”

But to be clear, we think it’s best not to have any subsidies or mandates.”

Competitive disadvantages

If Koch opposes subsidies and mandates, why have several Koch companies – including FHR, INVISTA, Koch Minerals...
and Georgia-Pacific—accepted a variety of government subsidies?
The answer is simple: competition.
“...We would be at a serious competitive disadvantage—and put thousands of jobs at risk—if we ignored the realities of today’s government-influenced marketplace,” Razook said.
“For example, the government’s ethanol mandate is a significant reason we’re in the ethanol business. We’re required by law to blend millions of gallons of ethanol at our refineries each year.
“In order to continue operating our refineries, it became a question of what is more cost-effective: buying the ethanol or producing it?
“So, for the sake of our business and our competitive position, we need to be involved in that industry at some point in the value chain.
“We will always follow the rules the government has established, but that doesn’t mean we have to like or approve of those policies. In fact, we oppose subsidies because we think they hurt the economy and our political system.
“This is why we continue to seek investments in assets that can create long-term value by economic, not political, means.”

A matter of principle
For decades, Koch leaders have consistently spoken out in opposition to subsidies, based on a belief in free markets.

As KII board member Richard Fink puts it: “We oppose subsidies because they distort markets. We maintain that the marketplace, while not perfect, is the best mechanism for allocating resources.

“Letting people, rather than the government, choose what to purchase is best for consumers and the country.”

Charles Koch, chairman and CEO of Koch Industries, has frequently commented on the problem of subsidies.

“Subsidies are usually promoted by those who seek to profit by political means,” Koch said, “rather than by fairly competing in a free market where consumers—not governments—choose the winners.”

As a recent example of this, he points to the proposed NAT GAS Act (H.R. 1330), currently awaiting action in the U.S. Congress.

This legislation would give billions of dollars in tax credits to those who buy natural gas-powered vehicles or invest in natural gas refueling stations. Its many supporters say it would be a boon to the economy and the environment.

“The NAT GAS Act may be well-intentioned,” Koch said, “but in essence it’s a misguided proposal. Passing it would give the natural-gas industry enormous new subsidies.”

“Think about it for a moment,” Fink said. “Instead of letting consumers choose what kind of fuel they want to use or vehicle they want to drive, the government would be dictating again, picking and choosing winners and losers, just like it did with ethanol.

“If natural gas vehicles are truly advantageous and economically efficient, producers already have the incentive to supply them without political mandates that exhaust more taxpayer dollars.”

Koch and Fink agree that subsidies do more than undermine economic well-being; they also corrupt culture in society and create a moral hazard.

“When our government guarantees profits for a select few and prolongs the benefits of political cronyism, we all suffer,” Koch said. “Entrepreneurship is stifled and American competitiveness and prosperity are undermined.

“In a profit-and-loss system, there is always the risk of downside, whether we realize it or not.

“If the government ensures that there’s no penalty for failure, why worry about succeeding or creating real value?”

Unreality
Dave Robertson, president and COO of Koch Industries, is especially concerned about the government’s tendency to make poor choices in the energy sector.

“The Obama Administration says it has spent $100 billion on renewable energy sources,” Robertson noted. “But these sources provide less than 3 percent of all U.S. energy. Is that really a wise policy?

“We should allow providers to compete on equal terms and encourage consumers to choose what works best for them, based on price, environmental standards or any other legitimate criteria.

“But that’s not a reality today. Government interventions are raising the cost of energy and taking us further in debt in the process.”

Robertson believes the government should eliminate all subsidies and preferential treatment, including credits, loans, mandates and favorable tax incentives.

“If you level the playing field and quit playing favorites,” Robertson said, “everyone has a chance to benefit—not just the chosen few.

“The very best thing Washington could do is take a big step back and allow the market to work.”
**Christmas quarrel**

When the Wood River Oil and Refining Company (now known as Koch Industries) finished building its independent refinery in 1941, the company’s biggest problem was political.

The U.S. Congress, shortly after declaring war on Japan and its allies that year, passed an excess profits tax on corporations. That tax was levied at a rate of 90 percent on every dollar of profit that exceeded pre-war averages. A year later, the rate was increased to 95 percent.

This punitive tax rate left Wood River struggling to retain an acceptable profit – even though the refinery was considered a vital supplier of high-octane aviation fuel.

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But there was another, less obvious struggle going on within the company during its earliest days.

‘Tis the season

As 1941 drew to a close, Fred Koch, who owned a 28 percent share of Wood River, suggested that the company pay a Christmas bonus to several employees who had worked so hard to get the refinery up and running.

That suggestion was opposed by another shareholder, prompting Koch to handwrite a four-page letter to I. A. O’Shaughnessy, one of the company’s co-founders.

In his letter, Koch listed several employees by name, the amount he thought they should be paid and the reasons why they had earned a bonus.

Altogether, wrote Fred, these employees “have been very loyal and have worked long hours and over weekends.”

Koch concluded the letter by writing: “I would prefer that [these bonuses] be taken out of my salary rather than them not to get it.”

Interest in principles

Given the differences of opinion at Wood River, perhaps it’s not surprising that the partnership didn’t last. (Neither did the excess profits tax, which was repealed, effective Jan. 1, 1946.)

Two of Wood River’s original shareholders departed in 1943. The other primary shareholder, Hank Ingram, parted ways with Fred, amicably, in 1950, the same year the Wood River refinery was sold.

The principle that Fred Koch stood up for 70 Christmases ago – that employees should be rewarded with a portion of the value they create – is now embedded in Koch corporate culture as the fifth dimension of MBM®, Incentives, and Guiding Principle 10: Fulfillment.
Instead of dwelling on what might happen in 2012 – as so many people are doing this time of year – it is essential for all of us to focus on something at least as important: our MBM® Guiding Principles.

Abiding by these principles should always be at the top of our to-do list, but especially in the heated political environment we’re seeing today.

We are now – as we have been for many months – under intense scrutiny. Our critics include many policymakers who seek to punish their opponents for purely political reasons. In circumstances such as these, actions, not intentions, are what count. No matter how well-intentioned we may be, if we are careless or make a mistake, we make ourselves an easy target for our critics.

This has been true for many years. But in today’s divisive environment, the consequences of any mistakes are likely to be amplified even more.

**Getting started**

Our goal as a company is to create real, long-term value for society, and to do so in a principled way.

That’s why our list of principles begins with integrity, followed by compliance. Both of these are required for true value creation.

If we lack integrity or disregard laws and regulations, we not only won’t create long-term value, we won’t be in business for very long.

This is why, if you see a problem that needs to be corrected, or have a genuine concern about a possible compliance issue, you must call attention to those issues.

Lack of authority is no excuse for inaction when it comes to compliance.

As I wrote in my book: “There is no excuse for failing to take a critical action, even in areas of shared responsibility.”

Failure to take responsibility “can be devastating, as when a government report is filled out improperly because the business leader, operations supervisor and compliance specialist all assume someone else is responsible.”

If there are any gray areas involving compliance — things that might depend on interpretation or even opinion — we must be especially careful.

**Cost of growth**

Last year’s results confirmed we are doing many things the right way. In fact, several of our businesses enjoyed record results and significant growth.

That kind of growth typically leads to job creation.

According to an independent study, last year, we already support at least 203,000 jobs in the U.S. More jobs are on the way.

As of Jan. 1, 2012, we had more than 2,500 open positions (200 of them international) across all Koch companies. At least one-third of these are new positions.

The essential challenge for our Human Resources team is not just hiring enough people, but hiring the right people — namely, those who not only have the talents and knowledge we require, but who also share our values and vision.

The right combination of virtues and talents is essential for success. Having one without the other is not only insufficient, but potentially dangerous (especially if we hire talented people who lack virtue).

**What to expect**

Despite the value we create, the jobs we support, our many charitable contributions or the hundreds of awards we have won in recent years, we remain a target of orchestrated attacks.

Given the barrage of criticism and misinformation we were subjected to last year, it doesn’t take a gift of prophecy to know that such attacks will only intensify and increase this year.

In a perverse way, these attacks show that we are making progress, otherwise we wouldn’t be criticized so much.

You should know that we will remain steadfast in our support of economic freedom, and of the greatest possible prosperity for all Americans.

But our efforts to advance the cause of economic freedom will be diminished if we shoot ourselves in the foot by not paying attention to our principles.

**To-do list**

In addition to abiding by our Guiding Principles, there are two things all of us can do to improve our future.

The first is to elect leaders who understand the principles of economic freedom and will do their very best to implement those principles as policymakers.

The second is to keep pressure on them to remain true to these principles.

What I said in my October 2010 Perspective editorial is still true: “If you are concerned about creating jobs, growing our economy and enhancing our quality of life, then you need to be concerned about electing candidates that support economic freedom.”

We must oppose those who promote runaway government spending, destructive overregulation and cronyism.

It is not too early to start doing your homework.